

FEE REIMBURSEMENT AGREEMENTS IN MANAGEMENT BUYOUTS

HEARING

BEFORE THE

SUBCOMMITTEE ON ANTITRUST,
MONOPOLIES AND BUSINESS RIGHTS

OF THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE CONCERNS RELATING TO THE REIMBURSEMENT OF FEES IN CONNECTION WITH THE ATTEMPTED BUYOUT OF UNITED AIRLINES AND WHETHER REIMBURSEMENT AGREEMENTS NEGOTIATED BETWEEN A BOARD AND ITS OWN MANAGEMENT ARE AGAINST PUBLIC POLICY

NOVEMBER 30, 1989

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FEE REIMBURSEMENT AGREEMENTS IN MANAGEMENT BUYOUTS

THURSDAY, NOVEMBER 30, 1989

U.S. SENATE,
SUBCOMMITTEE ON ANTITRUST, MONOPOLIES
AND BUSINESS RIGHTS,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:38 a.m., in room SD-226, Dirksen Senate Office Building, Hon. Howard M. Metzenbaum, chairman of the subcommittee, presiding.

Also present: Senators Thurmond and Specter.

OPENING STATEMENT OF SENATOR METZENBAUM

Senator METZENBAUM. The hearing will come to order.

This hearing will investigate whether the shareholders of United Airlines should have to pay a management-led group over \$58 million in fees and expenses for a failed buyout attempt. The hearing will also look at the broader issue of whether reimbursement agreements negotiated between a board and its own management are against public policy.

Earlier this year, in response to an outstanding offer to buy UAL for \$240 a share, which was subsequently increased to \$275, a group led by UAL chairman Stephen Wolf and the Air Line Pilots Association offered to buy the company for \$300 a share. A month later, the banks, which had said they were "highly confident" that they would be able to finance this heavily leveraged transaction, pulled away from the deal. On October 26, the buyout group terminated their offer to buy UAL. Today UAL stock is selling for \$165 a share.

Now, the management group, which squandered a chance for the shareholders to sell their stock for \$275 a share, is asking those same shareholders to pay for all the fees and expenses incurred in doing the deal. As a matter of fact, they've sent some of the checks out already. These fees are part of a deal struck between the management buyout group and the board of directors of UAL. This agreement required the company to reimburse the expenses and fees incurred by the buyout group even if the deal fell apart. When the deal did collapse, through no fault of the company, UAL shareholders were presented with a bill in excess of \$58 million.

I have difficulty understanding how so much can be spent to get so little. I question the excessive fees charged by investment bankers, bankers, the bridge loan banker, the attorneys, the consult-

ants, and all the others involved, including all of those who represented the buyers as well as the sellers—\$58 million for nothing sounds like a lot of money to me—but if someone wants to pay it, I have no quarrel if they are willing to use their own money. But why stick it to the shareholders?

Even if these fees were reasonable for the work done, it is a disservice to the shareholders of UAL that they are being asked to pay any money at all for the failure. Not only did the offer to pay \$300 a share never materialize, but an offer on the table for \$275 a share evaporated thanks to the failed buyout attempt.

The negotiation of this kind of agreement between the board of directors and its own management raises serious questions about conflicts of interest. Who was looking out for the shareholders? Not Mr. Wolf, who was cashing in his stock options and restricted stock for \$76.2 million. Not the management group, including Wolf, which were getting 1 percent of the company for \$15 million with an option to purchase up to 9 percent at the same price. And if my mathematics are right, that 10 percent would be worth something in the area of \$675 million at a cost of what I understand to be \$150 million. Not the board of directors, which was too busy granting itself such perks as lifetime air travel privileges and seeing to it that all directors would receive pensions of \$20,000 a year for life. Not bad. Both the management and the board were too busy adding up their gains to worry about wasting \$58 million in corporate assets in order to get the deal rolling. I believe that the agreement to reimburse these fees clearly violated the fiduciary duty the board and the management owed to its shareholders.

If there is a justification for this behavior, I would have liked to have heard it, but the UAL management has refused to appear and discuss the issue. They rebuffed an invitation to testify today. I believe they owe the shareholders an explanation. Their actions raise the question: How many other times have shareholders been called upon to pay the expenses of a failed LBO?

I have just received from my staff—and I'm not sure when this was delivered to them, whether it was late yesterday or this morning—a letter from Edward H. Hoenicke, senior vice president and general counsel of the company, and another letter from Mr. Stephen M. Wolf, who is one of the persons who was involved in putting the deal together, chief executive officer. Those letters will be included in the record at an appropriate place and are available to the press.

[The letters follow:]

UAL CORPORATION

Stephen M. Wolf
Chairman and President

November 29, 1989

Honorable Howard M. Metzenbaum
United States Senate
140 Senate Russell Office Building
Washington, DC 20510-3502

Dear Senator Metzenbaum:

I want to take this opportunity to reconfirm UAL Corporation's commitment to continue to cooperate with you and your staff with respect to your inquiry on the recent efforts to establish employee ownership of UAL Corporation.

I am sorry we were unable to reach each other by telephone, as I wanted to point out to you that, in order to maximize shareholder value and provide the security our employees so justly deserve, the company and its advisors are, among other things, exploring the possibility of structuring a new employee-led buyout. Thus, it was concluded that our participation in your public hearing could prejudice such discussions to the detriment of our shareholders. Accordingly, we believe it to be inappropriate for management of UAL Corporation to testify before your subcommittee at the present time.

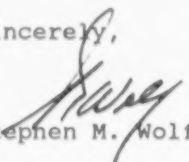
Once circumstances permit, I would be pleased to meet and provide you with any relevant information on this matter. As you know, in the past week the officers and advisors to the company have cooperated with your inquiry by providing your staff with extensive documentation and information, and they will continue to do so.

Honorable Howard M. Metzenbaum
Page Two

Attached is a letter from Edward H. Hoenicke, UAL Corporation's Senior Vice President and General Counsel, that addresses the expense reimbursement provisions contained in the UAL Corporation Merger Agreement.

Please make my letter and Mr. Hoenicke's a part of the Record of your hearing. We appreciate your understanding with respect to our position on this matter.

Sincerely,



Stephen M. Wolf

Attachment

Honorable Howard M. Metzenbaum
United States Senate
140 Senate Russell Office Building
Washington, DC 20510-3502

The Merger Agreement dated September 14, 1989, between UAL Corporation and Airline Acquisition Corp. provides that UAL is required to pay or reimburse AAC for all reasonable expenses actually incurred by it in connection with the transactions contemplated by the Merger Agreement.

Please make this letter a part of the record of your hearing.

Edward H. Hoenicke
Edward H. Hoenicke
Senior Vice President
and General Counsel

Senator METZENBAUM. Now, this hearing is not just about UAL, however. The UAL deal raises broad policy questions which must be addressed. Apparently, a cost-reimbursement agreement such as the one under discussion today is not unique, but that does not mean it is right. These agreements raise serious questions about a conflict of interest between the board of directors and the management group. I find it hard to believe that negotiations between a management group and its own board about the reimbursement of fees are ever really at arm's length.

These agreements also are unfair to other bidders and may result in shareholders not getting the full benefit of an open auction for the company. I am not saying that this is the case in the instant matter. I'm not certain about that. But when management already has an upper hand on other bidders because of its insider knowledge and control over the timing of the deal, allowing management to do the deal on a cost-free basis gives it too great an advantage in the bidding process.

I am also concerned that fee reimbursement can very well encourage management to fend off legitimate offers by throwing an economically unworkable deal on the table. There is no risk to management trying this self-serving maneuver, so long as the shareholders are committed to pick up all the fees and expenses if the deal fails.

And now a final word about an unusual aspect of this matter. In this deal, we have an employee group, made up of pilots and flight attendants, seeking to take over the company with the company executives because the employees are concerned that a well-run airline will be divided, sold, and disintegrated. They see what has happened to Eastern Airlines, Continental, Frontier, Braniff, Air Florida, People Express, and many other airlines. Understandably, they are anxious to preserve their jobs and preserve UAL as a viable competitive airline. To make this deal go, they were prepared to sacrifice immediate earnings in hope of strengthening the airline and preserving their jobs. I commend them for their efforts. I find no fault in their goal. But questions remain: Should the employees and management be reimbursed for their expenses when the deal fails? I think not.

I'm particularly pleased this morning to have the ranking member of this committee join us. Senator Strom Thurmond, I'm happy to have you with us.

OPENING STATEMENT OF SENATOR THURMOND

Senator THURMOND. Thank you, Mr. Chairman.

Mr. Chairman, our hearing today will explore the issue of fee reimbursement agreements in management-led buyouts. This hearing was prompted by concerns relating to the reimbursement of fees in connection with the attempted buyout of United Airlines by a group consisting of the management of United Airlines, the Air Line Pilots Associations, and British Airways.

Although I am anxious to hear the testimony of our witnesses today, it is my understanding that reimbursement fees are not uncommon in leveraged buyout transactions. I have also been told that such reimbursement expenses have been found to be accepta-

ble by the courts, especially in situations in which the board of directors has determined that these expenses are necessary to obtain the best value for the shareholders. The courts have taken the view that the amount agreed to be reimbursed must be reasonable in relation to the overall transaction. In the UAL transaction, I am told that the reimbursable expenses amounted to approximately 0.9 percent of the overall transaction, a percentage that is within the range of what courts have previously held to be acceptable.

Mr. Chairman, if we determine to pursue this issue after today's hearing, I believe we need to hear from other witnesses who have a different point of view. I understand that those involved in the UAL transaction were reluctant to testify because of ongoing negotiations with UAL that they felt might be jeopardized by public testimony at this time. I respect their position but feel that before we undertake any further consideration of this issue—and I am not now prepared to say that we should—additional views should be heard.

Mr. Chairman, as I noted at the outset, I am anxious to hear the testimony of the witnesses, and I thank them for their time and effort in appearing before us today.

I might say, Mr. Chairman, that on this matter I have an open mind.

Senator METZENBAUM. Thank you very much. I'm very pleased that you're here with us, and I'm looking forward to the testimony. We don't have a long line of witnesses to testify. We had hoped that we would have the UAL people testify we invited. I had also invited the people representing the Pilots Association. Both of them declined. I respect the position of all parties who have declined, and we would certainly be willing to hear from any who consider themselves experts in this field.

I might say parenthetically that you are right that this is not unique for the reimbursement to occur. But as I said in my opening statement, even though it is not that unusual, that doesn't make it right.

Our first witness today is a man whom I came to know over a period of some time when he was head of the Pension Benefit Guaranty Corporation which—

Mr. MONKS. Sir, the Pension and Welfare Benefits Administration in the Department of Labor.

Senator METZENBAUM. Pardon me. I stand corrected. Pension and Welfare Benefits Administration at the Department of Labor. Because I had some legislation in that area, we met and discussed matters over many, many occasions. I came to respect him. I know he left the Government several years ago and appears before us today as the president of the Institutional Shareholder Services of Washington, DC. We're very happy to have you with us, Mr. Monks.

STATEMENT OF PANEL CONSISTING OF ROBERT A.G. MONKS, PRESIDENT, INSTITUTIONAL SHAREHOLDER SERVICES, INC., WASHINGTON, DC; DANIEL KRASNER, PARTNER, WOLF, HALDENSTEIN, ADLER, FREEMAN & HERZ, NEW YORK, NY; AND BYRON S. KRANTZ, PARTNER, KOHRMAN, JACKSON & KRANTZ, CLEVELAND, OH

Mr. MONKS. Thank you very much, Mr. Chairman, Mr. Ranking. It's a great honor to appear before you.

May I say with great respect that I feel that when the history of our times are written, people will look back on the 1980's, and they will wonder: Was everybody asleep? Didn't everybody know what was happening? Couldn't they see what the problems were?

Mr. Chairman, I think the problems are very simply a matter of trust and the abuse of that trust. And with the greatest respect, I'd like to congratulate you for using your seniority and your respect to bring attention to this matter. It seems to me to be of the essence in protecting our marketplaces and our economies.

I would like, Mr. Chairman, to proceed to read a very brief statement and then would like to ask that my written remarks be entered into the record in the form that I've submitted.

Senator METZENBAUM. Please proceed, and I hope you will tell us who that group is that you represent.

Mr. MONKS. Yes; I'm very grateful for that.

Institutional Shareholder Services is an organization that represents owners, Mr. Chairman and Mr. Ranking. At the moment, we represent institutions who in the aggregate manage a thousand billion dollars of equity and debt securities.

Senator METZENBAUM. That's a trillion?

Mr. MONKS. It's a thousand billion. I think it's a trillion in American. In England, it's something else. A thousand billion dollars, Mr. Chairman. It's about a third of the capitalization of the stock markets.

Our clients include people like the pension fund of General Motors, the State of California, the State of New York, the State of Pennsylvania, the State of Florida, Fidelity Mutual Fund, Battery March, Alliance Capital—all categories of institutional investors.

As you Senators both know, institutional investors own control of corporate America, and it seemed to me that one way of trying to deal with questions of a healthy economy was to provide a way in which owners could relate to each other and could manifest their own interest, and then corporations could run themselves without reference to courts and without reference to legislation, as I see a healthy economy being one in which managements are effectively accountable to owners. The accountability has been difficult, Mr. Chairman, because while institutions collectively own say 70 percent of United Airlines, no one institution owns more than 4 percent. And so there's a real disincentive for each individual shareholder to act. What my organization tries to do is to provide a place where all of the institutions can find collective expression.

I appreciate your question, Mr. Chairman.

Management buy outs raise the most fundamental questions of trust. The inability of investors to trust the fiduciary managers they employ to manage property in their interest constitutes a

blight on the trading markets and, unless effectively curtailed, predictably will cause an erosion in values.

MBO's represent a conflict of interest. The problem is simply this, says former SEC Commissioner Bevis Longstreth:

Management is acting on both sides of the transaction. In its fiduciary capacity, management is seeking to sell the corporation and, therefore, must have concluded that a sale is in the best interests of shareholders. In its proprietary capacity, management is seeking to purchase the corporation, and must have concluded that it can do so at a price favorable to itself. In short, management is dealing with itself.

How can management possibly mediate fairly between its own interests and its shareholder's interests? It cannot and, predictably, the former will incline to prevail. This is why, Mr. Chairman, the ancient law of trusts inveterately and unchangingly does not permit a trustee personally to profit from his dealings with the trust estate. This is a far distance from where we are today and from the events that caused you to call this hearing.

That recent MBO's have served, first and foremost, the personal pocketbook interest of management needs only summary documentation here. Consider the massive sums management awards itself: Stephen Wolf, CEO of UAL, proposed personal profit approximating \$75 million in the failed UAL MBO. This actually pales in comparison to the deal made in the management-led Time-Warner merger. Steve Ross of Warner earned a salary/compensation/bonus package worth an estimated \$300 million. And the CEO of Loral, Bernard L. Schwartz, sold himself two divisions of his own company, despite a higher bid from Banner Industries, and billed himself about \$4,000 an hour to run them, still drawing full salary from Loral.

Then there is the issue of risk, Mr. Chairman. Presumably, the management of private companies—in contrast to public servants, elected and appointed—are entitled to their levels of compensation because they take risks. But with the advent of golden parachutes in the case of a change of control, any risk is only theoretical. The extent, Mr. Chairman, of management entrenchment is graphically illustrated on the cover of the current *Fortune* magazine, usually thought of as the "house organ" of corporate America.

Mr. Chairman, I'd like just to show you this cover, if you don't mind. *Fortune* magazine is not thought of as being a radical publication. This is the current one dated December 4, 1989—my birthday, actually—and it's entitled "The Trust Gap." And it says, "Pharaoh in all his glory would have envied today's CEO's their perquisites and ever-sweetening pay."

Thank you, Mr. Chairman. This, Mr. Chairman, is the background against which we have the discussions. This is the background against which I congratulated you for calling the hearings. Something is out of place. Something is wrong.

In an MBO, managements often take money out of the company and take less risk than when they ran but did not own it. For example, when Mr. Finklestein caused Macy's to be sold to himself in 1986, he only reinvested a portion of his prior holding in the \$3 billion deal. Mr. Wolf at United Airlines is trying a similar ploy: If the MBO had been successful, Mr. Wolf and CFO John Pope stood to take out of the company almost \$100 million over their continuing personal investment of \$15 million.

Mr. Chairman, the UAL transaction represents a crescendo of many unsavory trends in management-led buy outs. The deal included provision for the payment of certain legal and financing fees arising out of a failed MBO with \$53.7 million of UAL shareholder dollars. Clearly, the MBO had the effect of protecting management from a hostile takeover, and, if successful, of lavishly rewarding them. Why should shareholders bear the downside risk and pay the costs for a venture so blatantly in the principal interest of management?

There is, Mr. Chairman, no simple reason why all of this has come to pass. It can be understood in a simple sentence as one of the casualties of a time of greed. However, unless it is corrected, the adverse consequences will be severe and of long duration.

The right of a beneficiary shareholder to the loyalty of management should once again be rigorously asserted—through the enactment of a new Federal law preempting law setting forth a “bill of rights” for the tens of millions of Americans having beneficial interests in equity securities. Managements should once again be encouraged to align their interests with those of the owners.

Mr. Chairman, at the risk of trying your patience, I would like to recount to you a conversation I had with your distinguished, now deceased, colleague, Senator Javits. In 1984, when I was responsible for running the ERISA agency, which is responsible for the private pension system in this country, we had our own hearings for 10 years after you gentlemen had passed that incredibly important and successful piece of legislation. Senator Javits who, if you will recall, while physically disabled, was mentally not at all—not at all unable to make himself known. And at that time—under ERISA, Mr. Chairman, you may remember that you have continued expressly by statute in a piece of preempting legislation the time honored stricture that a trustee may not deal with the trust estate to his profit. That is the law of America with respect to pension assets.

A number of Senator Javits' former colleagues came to the hearings we had, and they said:

This has been such a pain in the neck. We have to go to the Labor Department; we have to get rulings. It's impossible. There are backlogs; it's terrible. Don't you want to change your mind? Shouldn't they be allowed to deal with the trust estate when there's fair consideration passing?

Senator Javits, if you will recall, who was in a wheelchair at the time, said, “I want to take a few minutes to consult with my colleagues.” And he went upstairs and revived himself, and he came down to the hearings. And when we readdressed him, we asked him the question. And Senator Javits said the following words that I will never forget. He said, “We are dealing with a very great evil, and we should continue the statute as we originally drafted it.”

Respectfully, you are dealing with a very great evil that is worth your attention and focus, and I congratulate you for it.

[The prepared statement of Mr. Monks follows:]

INSTITUTIONAL SHAREHOLDER SERVICES, INC.

UNITED STATES SENATE
Subcommittee on Antitrust, Monopolies and Business Rights
Committee of the Judiciary

MANAGEMENT BUYOUTS

Testimony by
Robert A. G. Monks
President, Institutional Shareholder Services,

November 30, 1989

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Management buy-out (MBO)--a process to permit management to take-over its own company--was developed as a way to allow small companies to go private when they needed to reorganize. Now, massive conglomerates use MBOs to fight hostile takeovers and disregard the interests of shareholders. An option that was created for one purpose is now being used for another, and the result is bad for shareholders, for companies, and for the American economy. Unless existing state laws or new federal legislation can contain MBOs, they will undermine the element of trust essential to the success of American business.

Our economic system mirrors our political system in one important respect; it is a system of checks and balances, designed to ensure that individuals with different skills and perspectives will be able to contribute, and that each contributor--labor, management, and capital, will have some accountability to each of the others. It was this system that resolved the issue Adam Smith thought insoluble--how to make sure that managers acting as the agents of those supplying the financing would act on behalf of their principals instead of themselves. Our system provides for that by allowing shareholders to contribute the capital, and elect the board of directors who then oversee the day-to-day operations. The board is held to a strict fiduciary standard--at least in theory--

which is enforced by shareholders, who can elect new directors, sue, or sell their stock, if that standard is not met. But MBOs permit utter violation of fiduciary standards, apparently with no recourse for shareholders, who must stand by helplessly as management uses their money to appropriate the assets of the corporation. An essential check is missing, and the result is a market out of balance, and a playing field that is far from level.

This applies even when an attempted MBO is unsuccessful. The recent MBO attempted by UAL, for example, would have given extraordinary compensation to management, if it had gone through. It did not--possibly in part because the self-dealing made the deal less attractive--but the costs of the failed deal are being borne by the shareholders, not the management group attempting the buy-out. This kind of investment, for this kind of loss, is unacceptable in any terms. When the investment was entirely for the benefit of the management recommending it, it becomes an outrage.

As troubling as some hostile takeovers and leveraged buy-outs (LBOs) may be, they do not present the central issue of every MBO--that management has an inherent conflict of interest. Management's use of its insider status to make money for individual managers, rather than the company or the shareholders, can be traced back to Mary Wells in the early 1970s. Wells took

her advertising company, Wells, Rich, Greene, Inc., public in 1968 at \$17.50 a share, and sold a new offering in 1971 at \$21.75. When she went private in 1974, the stock was at \$5.50 in the aftermath of the 1973 recession. All shareholders got for tendering was \$3 cash per share and \$8, 10-year debentures.¹ The SEC responded to this demonstration of the unfair advantage of insiders over shareholders with rule 13e that regulated privatization. This rule, by explicitly prohibiting certain types of actions, gave legitimacy to all others, and in essence established a blueprint for management to follow, allowing fiduciaries to feel secure in that, as long as they complied with 13e, they were being fair and just, and were protected from charges of breach of their duty as fiduciaries. Rule 13e, instead of a warning, became a blueprint.

The result has been a string of abuses, with some particularly disturbing examples this year alone. The Loral corporation, despite indications of a higher bid from Banner Industries, staged a mini-MBO by selling two of its divisions to its own CEO, Bernard L. Schwartz. According to court documents filed by Banner, Banner had expressed interest in the divisions two years before, when Loral acquired them. Loral told Banner that they were not for sale, but would notify them if they were put up for auction. Banner first heard about the proposed sale

¹ Berry, John F. "SEC Proposes Shareholder Protections," Washington Post, November 19, 1977, p. D9.

to Loral's own CEO in the press, and indicated its interest in making a higher bid. Loral then denied Banner access to information necessary in filing a formal bid and even refused to allow Banner to meet with the Special Committee of the Board that was convening to oversee the auction. Banner now claims that, based on information known to CEO Schwartz and the Special Committee, the divisions were worth even more and Banner would have made an even higher bid.² Apparently, Loral management was able to keep vital information secret, to keep a prospective bidder out of the running, and to keep the owners out of the decision-making process, all to permit the CEO to purchase two divisions at rock-bottom prices. Shareholders were not able to realize the potential gains of a fair auction. All they got was the continued service of the CEO for \$1.7 million, now with divided attention, and the privilege of paying him an extra \$4000 an hour for the time he spends running his own companies.³

In the case of the management-led Time-Warner merger, designed to prevent Paramount's bidding for Time on an open market, former-Warner CEO and current Time-Warner Co-CEO Steve Ross granted himself a salary, compensation and bonus package estimated to be worth around \$300 million by his retirement five

² "Loral Sued By Shareholders," ISSue Alert, September 1989 (Vol. IV, No. 7) p. 1,4.

³ Stevens, Charles W., "Loral Chairman's Buy-Out of Two Units Gives Him a Rewarding Second Position," Wall Street Journal, August 14, 1989, p. A5.

years from now. Though none of the other executives quite reached that price-range, they all received substantial sums. The irony of the Time-Warner deal, of course, is that it was completely recast, from an equity deal to a debt deal, in a matter of days, just to take the decision away from the shareholders, because management feared that they would prefer the Paramount offer.

The UAL MBO is perhaps the culminating event in this trend. In many ways, it perfected the breach of trust by taking the process to the next logical step: total protection of management and their team of lawyers and bankers. According to the National Review of Corporate Acquisitions, "The original unsuccessful transaction will long be remembered as a glaring case of overreaching greed and questionable judgement."⁴ Management at UAL acted on its own behalf, at shareholder expense, on two fronts: management compensation and exorbitant legal and financing fees, both vital parts of the MBO plan to support management interests. Stephen Wolf, CEO of UAL, followed the example of Ross at Warner and included in his MBO a healthy package totalling \$22.5 million in shares plus \$54.176 million in unexercised stock options, fully protected in the off-chance of a

⁴ Mufson, Steve, "Breakdown of a Buyout: Plenty of Blame Passed Around in UAL Takeover that Failed," Washington Post, Oct 29, 1989, p. H1.

change in control.⁵ The new company that Wolf would head was designed purely to keep UAL out of play. Wolf and John Pope, CFO of UAL, stood to gain \$114.3 million in a successful MBO, although UAL executives only planned to reinvest \$15 million in the new company.⁶ Taking into consideration that all of these managers also have lavish golden parachutes, it becomes apparent that MBOs have become a vehicle for guaranteeing extraordinary rewards for management, while protecting them from any risk.

Adding insult to injury--and adding further injury, too--shareholders are the ones who must pay the bills of the lawyers and investment bankers hired to carry out the MBO, even though it was designed to benefit management at their expense, and even though it failed. In the case of UAL, the bill was more than \$50 million. Citicorp and Chase each received \$4 million, Lazard Freres and Solomon Brothers split \$26.7 million in an unspecified proportion, Solomon got an additional \$3 million, and \$16 million went to repay a fund created for an ESOP.⁷ All this for a group that failed to raise the \$6.79 billion necessary for the MBO to occur, a failure which many thoughtful commentators consider a major factor in the stock market plunge of October 13.

⁵ "A Wolf in Wolf's Clothing," ISSue Alert, November 1989, (Vol. IV, No. 8) p. 5.

⁶ "British Air May Balk at Any Haste in Reformulating a UAL Buy-Out," Wall Street Journal, October 18, 1989, p. A3.

⁷ Smith, Randall, and Valentine, Judith, "UAL is Being Billed \$53.7 Million in Expenses from Failed Buy-Out Bid," Wall Street Journal, October 31, 1989, p. A8.

The UAL deal demonstrates how far you can stretch an unfair principle when no one is watching. The shareholders are taking the risk, even paying for management's support teams, whether they win or lose.⁸ Case after case demonstrates that management is taking advantage of their insider status to keep legitimate bids from shareholders. The problem is that this advantage is inherent. There simply is no way to conduct an MBO in a manner that is fair to shareholders. While Loral and UAL are good examples of the astonishing level of abuse that is possible in an MBO, it is important to keep in mind that even those MBOs conducted by responsible management, making every effort to ensure scrupulous fairness, are wrong because there simply is no process that will guarantee a level playing field when one of the parties controls the information and the agenda. Management just cannot bargain with itself, representing both the shareholders and its own interests. The fiduciary responsibilities of a CEO are not compatible with entrepreneurial efforts to preserve or attain individual power through corporate assets.

This may, in fact, have contributed to the failure of the UAL deal. Some observers believe that the UAL financing failed because of the management's self-centered behavior. "The bankers

⁸ It is useful to compare those cases where courts have permitted companies to make such payments for outside bidders--only where they will increase the likelihood of superior bids, not prevent them.

[who turned down the UAL proposal] said that UAL's management and advisers pushed too hard, trying to keep too much of the potential profit for themselves."⁹ It may be that the bankers realized that a good CEO is one who is not an LBO artist.

Clearly, an MBO is not a surefire way of enhancing revenues for the company and the shareholders when it involves paying over \$53 million to lawyers and financiers who actually failed to complete the MBO (as in UAL), or doling out \$300 million to a CEO from another company (Time-Warner), or depressing a stock price so management can realize a thousand-fold profit on a private-public scheme (Wells, Rich, Greene, Inc.), or keeps the company from selling at the best price because it wants to give it to the CEO (Loral).

If this were their money, we could relax. The risk of loss would prevent abuse. But it is not their money; it is the shareholder's money, and since at least 80 million Americans are shareholders, it is everybody's money. MBOs are being used to give job security and tremendous financial gain to a few people who are taking no risks. The Wall Street Journal, in an editorial comparing the takeover battles of Time in America and B.A.T. in Britain concluded: "It's better to be a shareholder in

⁹ "Flawed Portent: Banks Rejecting UAL Saw Unique Defects in this Buy-Out Deal," Wall Street Journal, October 16, 1989, p. A1.

Britain. It's better to be a lawyer in America."¹⁰ The simple fact remains: in America, the system works in the interest of the managers and the lawyers they employ. Managers and lawyers will always get paid, no matter what happens. Furthermore, they will get paid before the shareholders, and they will get paid with the shareholder's money.

MBOs represent a closed shop. Management has control over the information and the timing and virtual control of the price of the buy-out, thus effectively pre-empting any outside bidder. And management does not even have to bear the risks of their offer, as outsiders usually do--if it fails, let the shareholders pay for it. Management has a great deal to gain, and literally nothing to lose.

We have been told repeatedly by the more Panglossian economists that "there is no evidence that shareholders are being harmed. Regulation has substantially damaged the takeover market and thereby harmed the very shareholders that proponents of these action have said they want to protect. And now, we're on the verge of damaging the MBO market where we have voluntary transactions between shareholders and managers that seem to

¹⁰ "A Tale of Two Takeovers," Wall Street Journal, July 7, 1989, p. A10.

benefit everyone."¹¹ Michael Jenson, the very distinguished economist who made that comment, has attributed a huge decline in equity values to the loss of effective shareholder surveillance. But a more credible explanation is the loss of trust by investors and potential investors in the corporate system. Who is going to be motivated to invest in a system which tolerates--and, in some cases, even encourages--individuals who serve as fiduciaries to devote their prime energy to reorganizing the enterprise for maximum personal profit rather than enhancing the value of the enterprise itself? The single most important factor in the historically high market values of American capitalism was the atmosphere of trust that pervaded investments. Investors might as well gamble their capital in a casino that can change the rules in its own favor at any time as in a company like UAL.

Some observers acknowledge the conflict of interest inherent in MBOs, but believe it is not important. SEC Commissioner Joseph Grundfest has said, "A frequent concern in MBO transactions is that the managers purchasing the company are acquiring it at an unfairly low price. In support of this theory, critics often point to transactions in which management earns substantial returns in short periods of time on relatively modest initial capital investments. These individual instances, however, prove little if anything about the equity of premiums paid in MBO

¹¹ Jenson, Michael, "LBOs and the Reemergence of Institutional Monitoring of Managers," presented at the Conference on LBOs, NYU, April 1988.

transactions...The available evidence...indicate[s] that the premiums paid in MBO transactions are comparable with the premiums paid in third party merger transactions. These results should not be surprising; if the board of a company considering an MBO proposal has an obligation to conduct a fair auction that yields stockholders the highest possible price, then management will be unable to complete an MBO unless it is willing to pay at least as much as competing third party interests."¹²

The outsiders' failure to outbid the insiders does not prove anything, because the insiders control the information. If the outsiders bid less than the insiders, we can assume it is because there is some value that the insiders are not disclosing (as Banner is alleging in its suit against Loral). There is no such thing as a fair auction in an MBO. The information advantage, the timing advantage, the total control over the corporate pocketbook, and the accessibility to advisors who are experts on the company all serve to grant managers limitless power.

There is clear interest by all corporate constituencies in raising the level of values, and management is in a unique position to be able to commit to a particular price. Therefore, all interests are served so long as some kind of fair auction

¹² Grundfest, Joseph A., Commissioner of the SEC, "Management Buyouts and Leveraged Buyouts; Are the Critics Right?," prepared for the Conference on Management Buyouts, NYU Graduate School of Business Administration, May 20, 1988. at p. 15, 16.

environment exists to prove the fairness of the price. However, so long as management is free to be involved as a principal in LBOs, then it has an interest in the company's having a low stock price, which conflicts sharply with the shareholders' interests in value--both as reflected in trading price and in any bid. Traditionally, the CEO is concerned primarily with the values that the market places on ownership of the company he or she runs. Both legally and practically, the CEO is required to assure that the market fairly and fully values the company stock. Inevitably, however, there will be times when the market places an inexplicably low value on a company's stock. Accounting rules sometimes tend to require an artificially low level of earnings, for example, which drives the market price down.

In such a case, the cost of 'privatizing' a company can be accomplished at a price with a healthy premium over present market values. This leads to the conclusion that the company, with proper management, can manifest higher values than those currently assigned by the market. It often appears that the company can operate with less equity (sometimes, this means no equity) and more debt; that many of its assets can be sold and some leased back to increase the leverage of risk; that divisions can be expunged; that layers of management are redundant and thus expendable; the headquarter perks are not necessary for profit generation; that cash flow can be increased in the absence of need created by the public market; and that compensation

arrangements can be constructed to more effectively align management's interests with that of the owners. Who better to effect these value-adding changes, the economists ask rhetorically, than management itself? The question begs far more important questions: is the cost of these changes being borne by the right parties and are the changes of sufficient value to outweigh the cost?

MBOs are supposed to be priced by value, not trading price, but that is not the case. Listen to Ross Johnson, CEO of RJR, described his company's transaction which began as an MBO:

"So Charlie [Charles Hugel, CEO of Combustion Engineering and chairman of RJR's Board] came to me and said, 'Ross, we want to make sure that the number you were thinking about was not frivolous.' I said 'Define frivolous.' They said, 'The number has to be north of the highest price that this company's stock has ever traded at.' And I said, 'Fine, I can do that.' I had to get a number; Shearson and I didn't even have a number written down. I said to the bankers, 'You can't go with \$72 or \$73 a share' which is what they wanted to do. 'You've got to go \$75. One time the stock hit \$71.' Our stock was trading in the low 50s then so that seemed like a hell of a big premium to me."¹³

Even after days of excoriating criticism, Ross Johnson was able to describe his bid only in terms of what a premium represented over current market value. Despite Johnson's fiduciary duty of loyalty to the shareholders, there is a complete lack of a sense of duty to the shareholders of RJR to make them an offer that

¹³ Saporito, Bill, "They Cleaned Our Clock," Fortune, January 2, 1989 at p. 73.

correlated to what he knew¹⁴ the value would be.

Sam Heyman, whose MBO at GAF stands as an example of how even the most careful and responsible MBO cannot be fair to shareholders, showed how little value matters when he revised his bid, following the 1987 stock market crash. Heyman originally offered \$66.50 for each share of GAF common stock in September 1987, which was rejected by a special committee of GAF's independent directors then withdrawn by Heyman himself after the October stock market crash. He then offered bids of \$48.50 and \$51, which were also rejected by the special committee. The final bid \$53 -- \$46 in cash and subordinated debt with a face value of \$7 -- was accepted by the committee save for one man, who recognized the fallacy of the process. Daniel T. Carroll dissented on the basis that the bid (and all previous bids) "does not reflect the long-term values of the Company."¹⁵ To management, a company's asset value does not change with a sudden drop in the entire stock market, yet to the management trying to purchase those assets, it does.

Managers preparing for an MBO rely on the theory that

¹⁴ Leinster, Colin, "Greed Really Turns Me Off," Fortune, January 2, 1989 at p. 70, quoting Henry Kravis: "...the one thing we were very certain of was that the management group was stealing the company...Based on the analysis we'd done, we knew it was worth a minimum of \$90 a share."

¹⁵ GAF Proxy Statement and Prospectus, dates January 23, 1989, at page 27. "Mr. Carroll's view is based on his familiarity with the Company, their financial performance and prospects."

managers are more efficient when they are owners and not just employees. Whether or not this is true remains to be seen, but their actions have lent some credence to the theory that managers are more greedy when they are owners and not just employees. They are also more given to undervaluing a company before the MBO, risking little of their own money in the venture, and eventually returning to the public realm for even greater personal gain.

Take the case of Macy's, taken private by its Chairman Edward K. Finklestein in 1986, according to one article, Finklestein was not exactly telling the truth when he made his \$68-per-share tender offer, which was 50% above market price and allegedly 165% of the book value of the company.

"Macy's owned eight shopping malls. Because American companies hold assets on their books at cost, the old Macy's listed the malls at a total value of \$100 million. Perhaps it appeared generous, therefore, when Finklestein and his associates valued the malls at \$250 million in the buyout...Three months after the buyout, Finklestein sold the malls to an Australian company for \$555 million. Why didn't Finklestein get the bright idea to sell the malls six months earlier when he was still working for the public shareholders?"¹⁶

Finklestein made an immediate \$9.7 million on his own tender offer, yet reinvested less than \$4.4 million, meaning that "he had less of his own money riding on the future of the company after his buyout than before."¹⁷ And Finklestein's \$4.4 million investment was worth \$122.5 million in 1988. Furthermore, Macy's

¹⁶ Michael M. Lewis, "Leveraged Rip-Off," The New Republic, November 14, 1988, p. 27.

¹⁷ Ibid., p. 26.

has registered for a public offering of their stock, which is the ultimate debasement of the theory that MBOs make the company more efficient. In 1987 alone, there were 47 reverse LBOs, against 54 MBOs. Clearly, the MBO is not as good for the long-term interests of the company, than it is for the short-term interests of the managers.

Finally, MBOs can result in the totally destruction of a company. Lowell Sachnoff, speaking at the University of Michigan, recently discussed the Fruehauf defense against the Asher Edelman takeover attempt: "The company used a whole range of defenses that culminated in a management-led LBO. And the price got so high that two and a half years later, like the general commenting about the town in Vietnam that had to be destroyed to save it, the company seems to have been destroyed...Mr. Rowan, who was CEO at the time, recently said (and I quote), "Personally, I think we should have let Edelman take it."¹⁸ The management, in fact, gave shareholders a good deal on their investment for the short-term. Yet they incurred massive amounts of debt that, in effect, sunk the company in the long term.

The very structure of MBOs places management in a Catch-22: management must be faithful to its own interests not to waste

¹⁸ "Corporate Governance: The Role of Boards of Directors in Takeover Bids and Defenses; A Roundtable Discussion," The Continental Bank Journal of Applied Corporate Finance, Summer 1989, p.20.

money and thus acquire the company cheaply, yet management simultaneously must be faithful to the shareholders and pursue their interests, meaning obtaining the best price for the company. It is like playing checkers with yourself, and betting on one side to win.

Can a practice so riddled with the possibility of corruption be legitimated by a process that grants higher returns for shareholders? Thoughtful commentators have suggested that "mandated open bidding" preserves the benefits and provides the protection against the conflicting interests of management inherent in MBOs.¹⁹ The continuing ability of management to control the corporate pocket book appears to be an insurmountable hurdle to developing "process" solutions to the problems of MBOs. Having "fairness" opinions from financial experts looks attractive on paper; but in reality, it means very little. Value is highly subjective, and writers of fairness opinions, like expert witnesses, can be found for just about any proposition. Management selects and retains the people who write fairness opinions and provides them with the information on which they base their opinions. What kind of cooperation can be expected from corporate officers in providing "fair and complete" information about their operations to potential bidders who are

¹⁹ Lowenstein, Louis, "Management Buyouts," 85 Columbia L.R. 730 (1985) and articles cited therein, particularly the speech by the SEC Commissioner Bevis Longstreth to the Toronto Bar Association, 10/6/93.

bitter competitors of their once and future bosses? Not only is it unrealistic, it is unfair to put employees and service providers in the position of having to put their futures at jeopardy depending on how their attitude is perceived by management and outside bidders. The term "fairness opinion" thus becomes virtually oxymoronic.

The RJR transaction has also sparked litigation to define the scope of management responsibility to bondholders. Outstanding bonds include a debt offering in the Spring 1988 managed by Shearson Lehman Hutton (the same firm that promulgated the October MBO offer) and the Ross Johnson-led management whose value along with the rest of the corporation's debt declined some fifteen percent. The courts will decide whether there is such a thing as 'fairness' owed to bondholders in addition to the protections afforded by specific provisions in the debt instruments.²⁰ The proposed MBO raised the further question of management's activities transferring value from the bondholders to itself. In the Ross Johnson proposal, management was to have a 'carried interest' valued in the hundreds of millions of dollars

²⁰ All this occurs in times when lawyers receive without apology \$20 million for two weeks work. One wonders the extent to which the bondholders might allege that their losses were due to the negligence of their counsel who had failed to provide contractual assurance of adequate asset and cash flow coverage for their securities to maintain their rating level. Who would they hire to press such a charge? Possibly, the courts will conclude that the bondholders were neither inexperienced nor incapable of sophisticated representation and that they are entitled only to what they bargained. To what extent are the lawyers at fault?

which approximate the amount of the loss of the bond holders. By flatly prohibiting MBOs, at least the capacity of management to transfer debt holder values to themselves will be eliminated.

America has suffered in the past from epidemic breaches of trust. Before the passage of the Employee Retirement Income Security Act of 1974 (ERISA) for example, there was widespread theft and fiduciary failure that threatened the financial survival of the country's retirement income system. The enormous scope of ERISA in the area of prohibited transactions, however, produced a backlog at the Department of Labor to grant exemptions. In 1984, former Senator Jacob Javits, an author of the legislation, testified before the National Pension Forum in the face of strident criticism of the immense power of ERISA. No doubt recalling such instances as the criminal administration of the Central States Teamsters and the looting of the public employee pension funds to save New York City, Javits stated: "I believe the prohibited transaction provisions should be maintained because we are dealing with a very great evil of the days before ERISA..."²¹ (emphasis added).

Continuing to permit a system that provides more incentive for management to deal with corporate assets in their own interests than to increase productivity and value for the good of

²¹ Department of Labor, ERISA Advisory Council, The National Pension Forum, September 12, 1984, transcript at p. 28.

the stockholders, and the country, is an evil similar in nature to the one Senator Javits helped prevent. Both instances involved self dealing and breaches of trust, one by ERISA fiduciaries, one by management of larger, publicly-held corporations. There is a need for new legislation. At a minimum, it should prohibit MBOs. If management wants to buy the company, let them quit, open up an office, wait six months, and make a bid, just like anyone else. One of the basic attributes of accepting a fiduciary position in the management of a corporation should be the loss of eligibility to become involved as a principle in the takeover of the company.

Louis Lowenstein recognized this problem in 1985, when he asked: "Can we expect the states to develop a neutral and effective framework for control contests? They have intervened in the takeover area in ingenious ways, but the statutes have uniformly regulated bids, not defenses to bids. A sense of even-handedness is missing. The rub is that for Delaware and other states the 'market' is not shareholders but managers, and nothing is so important to managers as corporate control. The problem becomes a federal one, therefore, not by desire but by default."²²

There are many problems that will need to be addressed: problems of scale - how does one mitigate the impact of a new

²² Lowenstein, Louis, "Management Buyouts," 85 Columbia L.R. 730, 784 (1985).

preempting federal law on the economy of the country; problems of equity; problems of definition - what is an MBO, how would a prohibition affect the merger of subsidiary and parent corporations. Possibly, the same solution used under ERISA (Sec. 408) would be serviceable, namely, an exemption process.

One problem is of transcending importance. Every effort must be made to assure that incentives continue to be created for management to align its interests with those of the owners (in the parlance of economics, "to reduce agency costs"). Management, having a non-diversified investment in a specific career, is certainly entitled to compensation in the event of a takeover that results in loss of job. Great attention will need to be paid to working out fair compensation, to avoid making management opposition to any and all takeovers inevitable. There should continue to be devices, like stock purchase and option plans, for management to maximize the extent of their investment in the company that they manage. We must remove, however, the mixed messages that the existing environment gives to management; they cannot be allowed to occupy positions contrary to the interests of shareholders.

Senator METZENBAUM. Thank you very much, Mr. Monks. We'll have some questions, but I think I'd like to hear from the other witnesses first. We'll hear from the entire panel, and then we'll go to the questions. We do appreciate your testimony very much.

Would you repeat for me once again? The people you represent speak for 30 percent of the—what percentage did you tell me of the total market share?

Mr. MONKS. The usual data is that there are \$3 trillion in stocks in the country, and the people who we represent manage a thousand billion dollars, which is \$1 trillion.

Senator METZENBAUM. One-third.

Mr. Krasner, as I understand it, you are a lawyer who has brought an action in connection with this matter. You also are an individual shareholder of UAL stock. Is that correct?

Mr. KRASNER. Yes, Mr. Chairman. That is correct.

Senator METZENBAUM. We'll be happy to hear from you, sir.

**STATEMENT OF DANIEL KRASNER, PARTNER, WOLF,
HALDENSTEIN, ADLER, FREEMAN & HERZ, NEW YORK, NY**

Mr. KRASNER. Good morning, Mr. Chairman. Good morning, Senator Thurmond.

I am a lawyer who specializes primarily in——

Senator METZENBAUM. Move the mike toward you a little bit. That's good. Thank you.

Mr. KRASNER. I am a lawyer who specializes primarily in representing minority stockholders in shareholder litigation. I am also in this case a small shareholder of United Airlines. I am pleased to speak to the committee today regarding what I believe is one of the most egregious examples of management overreaching: UAL's board of directors agreement to obligate the shareholders of UAL, in effect, to pay over \$58 million in fees incurred by UAL's management in a failed attempt by that management to take over and buy UAL for itself. This transaction from its very inception was structured to constrain an open auction for UAL and to disproportionately profit its own management. As a result of what has happened, there is no tangible benefit to UAL's shareholders. Nevertheless, they are left holding a \$58 million bag.

In fact, what has happened as a result of this failed transaction is the UAL stock price, which had been approximately \$280 a share, has now declined to, I believe, Mr. Chairman, as you pointed out, to \$165. According to this morning's newspaper, it's down to \$160, approximately half of what it had been at the time that this offer was outstanding. This is a loss in value to shareholders of approximately \$2 billion.

I would preface my remarks by pointing out that I am not adverse to the concept or the business reality of mergers and corporate takeovers and corporate buy outs. I am not opposed to hostile takeovers. They serve a particularly useful function in our economy. They eliminate inefficiency; they promote efficiency; and in the long run, they generally do promote the most efficient use of our national assets. Nor am I opposed by any extent to investment bankers or attorneys or bankers earning appropriate fees in the proper circumstances. The amount of fees that were involved here

are not necessarily excessive. It is the concept that these fees were paid despite the fact that this transaction failed that bring these fees into question and bring into question the appropriateness of the shareholders' footing the bill for management's failure to consummate the transaction.

I personally, as a lawyer representing minority stockholders, am seriously concerned about this because, in my profession, our fees are only paid if we succeed. If we succeed in making a recovery for a minority stockholder and for stockholders of a company, then the court in its discretion awards us a fee. If we do not succeed, we get paid nothing. In this particular instance, and in many instances like it, the lawyers, the investment bankers, the bankers, everybody connected with the transaction gets paid as much for failure as he does for success.

I question whether this kind of agreement, an agreement whereby the management of a company is, in effect, rewarded for failure as if it were success, is appropriate. In the ordinary arm's length transaction that most of us engage in, whether it be the sale of a home, the sale of a business, the sale of a piece of property, it is unheard of for the buyer to come to the seller and say to the seller, "I'll pay your price if you will agree to reimburse me for all my costs if I can't finance the transaction."

To bring it down to a more human level, in the situation where a person is selling his home and a buyer comes along and says, "I'd like to buy your home. I'm willing to pay your price, but I'm not sure I'm going to be able to get the bank financing," it's unheard of in that context for a contract to be written whereby the seller agrees to pay the buyer's lawyer, the buyer's bank fees, and the buyer's other expenses to find out whether or not he's going to be able to close the transaction.

In the ordinary arm's length transaction, this never occurs. Nevertheless, in the context of a multibillion-dollar transaction, dealing with large sums of shareholders' money—that is, other people's money—we are told that such an agreement is proper and acceptable. But who tells us that? Isn't it this very same people that benefit from the transaction; that is, the lawyers and the investment bankers who would otherwise not be compensated when this transaction fails? These very same lawyers that advised the board of directors of United Airlines that it was appropriate to enter into this contract in the next transaction may be representing the buyer. Therefore, they find it in their interest to advise that it is appropriate for the company to reimburse a failed buy-out attempt and to reimburse, in effect, the lawyers, the investment bankers, and everybody for their time and expense in connection with that attempt.

This to me is a basic conflict of interest. It's a conflict of interest that runs to the heart of the system. The management is supposedly at arm's length with the directors in negotiating the transaction, but this is not what really occurs in the real world. In the real world, the transaction is negotiated over a very cozy table where on one side of the table sit the same people that sit on the other side of the table. There is no adversariness in that negotiation. It is unheard of in an adversary negotiation for the seller to pick up the costs of the buyer.

It should be emphasized here that the decision by UAL management to pursue this buyout was in part an attempt on their part to take the play away from a third party who had also come in and offered to buy the company. This third party was prepared to negotiate a transaction at or higher than the price that management ultimately paid. Nevertheless, the nod was ultimately given to management, and then we find out that management risked nothing in making this offer because, in effect, the board of directors indemnified them for their entire expense in making the offer.

The net result is that the third-party buyer who, in order to get access to the same information that was available to management, agreed not to make a hostile offer for the company, now has his hands tied and can make no offer for the company. Meanwhile, management's offer has failed, and the price of UAL stock has gone from \$280 a share to \$160 a share.

Another example in corporate governance of the same type of transaction and the same control that management has over the operation of the company, even in situations where its interest is adverse to that of the shareholders, are the blessed transactions involving what are called poison pills and other takeover defenses. The poison pill and other takeover defenses are designed to restrict certain types of takeovers, and they do serve a purpose where a hostile takeover is attempted, where the hostile takeover company is not trying to buy all of the stock at the same price. The poison pill can prevent that. But, in effect, what has happened is the takeover defenses have been used to thwart outsiders from coming in to take over a company and preserved the company for ultimate acquisition by management, by the insiders.

In effect, the takeover defenses have permitted the board of directors of a company to choose the final acquirer. Who is going to acquire this company? Is it going to be management or the third party? And, in effect, management usually, if not always, gets the nod.

The net result of all of this is that the minority shareholders suffer when the transaction fails, and when the transaction succeeds, on many occasions we wonder whether the highest price was achieved. As Mr. Monks, the prior speaker, pointed out, there are many occasions where higher offers are rejected by a board of directors in favor of a lower offer from management. On many of these occasions, there are justifications for accepting the lower offer. There are rationalizations for it. But given the fact that management is on both sides of the transaction, one always has to wonder whether it is a justification, or is it really just a rationale for preferring the insider over the outsider.

I believe this committee should carefully scrutinize these transactions and that this committee should consider the possibility of legislation to put management on an equal footing with the outsider and not put management in the position it currently is where management has the best and easiest opportunity to make the acquisition, and the outsiders are always climbing up that very steep hill.

Thank you.

[The prepared statement of Mr. Krasner follows:]

TESTIMONY
OF
DANIEL W. KRASNER
BEFORE THE
UNITED STATES SENATE
JUDICIARY COMMITTEE
SUB-COMMITTEE ON
ANTI-TRUST, MONOPOLIES
AND BUSINESS RIGHTS

NOVEMBER 30, 1989

Good Morning – my name is Daniel Krasner. I am here in several capacities today. I am a shareholder of United Airlines Corporation and have been since 1987. I am also counsel in a lawsuit pending in the Chancery Court in Delaware that was brought on behalf of all public shareholders of UAL challenging the terms of the aborted UAL management-led going-private transaction. Additionally, I have specialized for almost 25 years in representing minority public shareholders in litigation involving securities fraud, corporate governance, corporate mismanagement and unfair dealing.

I am pleased to speak to the Committee today regarding one of the most egregious examples of management overreaching. UAL's Board of Directors' agreement to obligate the public shareholders of UAL to pay over \$53 million in fees incurred by UAL's management buy-out group in their failed effort to take UAL private is a clear act of corporate managers favoring themselves over public shareholders. This transaction was structured to prohibit an open auction for UAL and was intended to profit UAL management disproportionately. It resulted in no tangible benefit to UAL or its shareholders. In fact, it has resulted in UAL's public shareholders seeing the value of their shares decline from \$280 per share to nearly half that value, or a diminution in value of almost \$2.5 billion.

I preface my remarks by pointing out that I am not adverse

to business mergers and corporate buy-outs – even hostile takeovers. Nor am I opposed to the payment of generous fees to investment bankers, attorneys or even lending banks for a successful transaction. These fees are often legitimately earned. The transactions that generate such fees in many instances bestow significant benefits on shareholders and our economy. However, the UAL transaction involves the all too common excesses that result from insider transactions such as management LBO's.

UAL's senior corporate managers, with the acquiescence and assistance of their colleagues on UAL's Board of Directors, agreed among themselves, without shareholder approval, to underwrite the expenses of management's failed attempt to take UAL private. This private agreement provided for the payment of management's expenses whether or not management's efforts were successful. Thus, UAL's shareholders are committed by the Board of Directors to pay the freight for management's inability to finance or obtain financing to consummate its offer.

It is commonly accepted that the ability to finance the transaction should be the threshold question posed by a disinterested Board of Directors. Directors must determine, before opting for one potential corporate acquiror over another, whether the potential suitor has the wherewithal to finance the deal.

The risk of failure once an agreement is reached, however, should not be borne by the shareholders who are being asked to sell their shares. It is unheard of in a true arms-length transaction for the seller to assume the buyer's risk if the transaction fails. For example, have you ever heard of a seller of an asset such as an office building or residential property agreeing to pay the buyer's costs -- bank fees, lawyers, investment bankers, and the like -- if the deal fails? The ordinary seller would never consider such a transaction.

Yet we are told such an agreement is perfectly acceptable in billion dollar corporate deals. But who tells us that? The same bankers, lawyers and investment bankers who might otherwise be asked to assume that risk themselves. How can we trust their judgment when they are so conflicted? One day they represent the seller, the next day the buyer.

It must be emphasized to the Committee that the decision to pursue a UAL management-led buy-out was reached to deter a non-insider third party from mounting an effort to purchase UAL, at the same price as the management-led offer. This acquiror, Marvin Davis, had the resources and reputation to consummate a transaction at a price of that magnitude. No one asked Mr. Davis if he would do the deal without asking UAL's shareholders to assume the risk and

expense of failure. Instead, the directors embraced management's offer.

One of the reasons management got the nod is the inherent unfair advantage management has in a going-private transaction. Company managers have at their fingertips all non-public information concerning the company's financial condition and prospects; the ability to obtain forecasts of future sales and profitability from the Company's employees who work under their direction; the ability to plan their takeover strategy in secret for a long period of time and choose the most opportune moment to launch their bid; and, finally, a very cozy relationship with those Board members who are supposed to be their adversaries in the negotiations. Outsiders are correspondingly disadvantaged because internal financial information is generally unavailable to them and management often refuses to provide this information to serious potential acquirors without draconian conditions. For instance, UAL repeatedly refused to provide information to Marvin Davis until Mr. Davis agreed to conditions that virtually eliminated the possibility that he could mount a counter-proposal. Even now, these conditions prevent him from making an offer.

Another example of management's ability to insulate itself from potential competing offers is its unchecked power to institute anti-takeover defenses before an offer is made. "Poison pills" are one

such defense. The Committee should note that poison pills are not designed to restrict all takeovers. Instead, these devices are usually triggered if a potential acquiror surfaces who is not approved by the corporation's Board of Directors. No poison pill, to my knowledge, has ever been triggered by a management-led buy-out. As a result, the position management forces on a corporation is all too often, "if management is the buyer, the Company is for sale; if anyone else is the buyer, the Company is not for sale." Likewise, the ability to trigger poison pills against unfriendly acquirors often results in negotiation of lavish compensation packages and golden parachutes for outgoing management, usually reducing the amount that would otherwise be available to compensate shareholders for their stock.

Even after an offer has been made, the target company's management still has extensive power to choose the victor and set the terms of the deal. For instance, friendly management buy-outs often include preferential terms such as those involved in the UAL deal. In other situations, management buy-outs have included what is sometimes referred to as a "lock-up option," or a multi-million dollar fee (called a "break-up fee", or "topping fee") which is triggered if a higher, outsider's bid is made.

These fees often have the economic effect of making a potential transaction at a higher price too expensive or lowering the

offering price below what would otherwise be available. Thus, any meaningful and honest auction for the subject company is eliminated.

Under current state law, management has a free hand to effect anti-takeover devices and enter merger agreements with terms similar to or even more onerous than those in the UAL deal.

States have a long tradition of crafting corporate laws and state courts have a long tradition of interpreting such laws with a presumption in favor of the directors' business judgment. While these laws have a rational foundation and are necessary for the normal day-to-day operation of corporations, modern-day takeovers present a unique challenge to corporate directors that were not taken into account by the principles of corporate governance originating in English common law. State law has simply not kept pace with the unique problems of corporate governance in the going-private transactions where large, widely held public companies become merger and acquisition targets.

The UAL transaction – particularly, its ultimate cost to UAL's shareholders – highlights the essential conflicts of interest inherent in management-led transactions. Pre-emptive federal legislation to level the battle field would serve the national goal of managing our resources to promote their most efficient and best use.

Thank you.

Senator METZENBAUM. Thank you, Mr. Krasner.

Our next witness is Mr. Byron Krantz, who is a partner in the law firm of Kohrman, Jackson & Krantz of Cleveland. I should say to my colleagues, as well as to others, that I have known Mr. Krantz a long, long time. He was a member of my law firm. He was a partner of mine many years ago, and he left my law firm, and went out on his own. He appears here as a well-respected corporate lawyer. I think he left my law firm something about 18 years ago, if I remember correctly something like that. But I'm very happy to have him here. He's certainly well known and well respected as a corporate lawyer in the Cleveland community and nationally as well.

Mr. Krantz, happy to have you here.

**STATEMENT OF BYRON S. KRANTZ, PARTNER, KOHRMAN,
JACKSON & KRANTZ, CLEVELAND, OH**

Mr. KRANTZ. Senator Metzenbaum, Senator Thurmond, thank you for inviting me to be with you today.

I come to this committee in quite a different light than the other speakers. I'm a lawyer who earns his living by representing management groups and buyout groups in acquiring corporations. I've divided my presentation into two sections. One I've called the "Anatomy of the Expense Reimbursement of a Recent Management Buy Out," a situation in which there was absolutely no expense reimbursement. The second part I would like to deal with some public policy that I think this subcommittee ought to consider.

I would like to recount for the subcommittee's benefit a buy-out that was successfully concluded just a few months ago, as I said, without the benefit of any prior reimbursement agreement. The company, SunMedia Corp., owns suburban newspapers in Ohio and Wisconsin. The chairman of the company owned 7.5 percent of the company stock while the president owned 15 percent and employees approximately 3 percent. The shareholders who owned approximately 50 percent of the company were interested in selling their stock at the best available price. These shareholders were investors not employees. Both the chairman and president prevailed upon the outside shareholders to allow them to have the first opportunity to purchase the shares at a negotiated price.

The transaction cost of buying investor stock and retiring the investor debt and the other shareholders' stock was in excess of \$40 million. Instead of negotiating with the investor group for reimbursement of the investment banking fees, the commitment fees, the due diligence fees, the professional fees, Mr. Weinberg, the chairman of SunMedia, chose to advance the fees. The reasoning was quite simple: If he succeeded in concluding the transaction, management fees would be reimbursed from the proceeds of the acquisition. On the other hand, if management had used corporate funds to finance an attempted acquisition which ultimately failed, we, as his legal counsel, and he felt that he would be subject to appropriate criticism from the shareholders who were not part of the transaction for a violation of his fiduciary duty to those shareholders. Patently, the board of directors of this company would have

consented to the advancement. The board of directors was controlled by the people who wanted to sell their shares, the 50 percent shareholders. Mr. Weinberg obviously was on the board as was the president. In any event, it was determined by Mr. Weinberg that it would be an inappropriate expenditure of corporate funds if he sought reimbursement of moneys advanced.

Frankly, it isn't even reimbursement. It's payment. The euphemism "reimbursement" is wrong. What basically happens in these agreements is the corporation pays the fees incurred by the management group.

As a result of the restricted-checkbook method of financing his LBO, Mr. Weinberg was able to negotiate fees to prospective lenders and bankers conditioned solely upon the closing. The only costs—and this to me is very meaningful. The only costs advanced were the due-diligence costs for actual out-of-pocket expenses incurred by the financial institutions, for traveling to the sites, for hotel stays, for meals, and things of that nature. That was the only cost Mr. Weinberg had to advance in a transaction which, I've said, exceeded \$40 million. This approach clearly benefited the selling shareholders, the corporation, and Mr. Weinberg as a buyer. Restricted expenditures have a leavening effect. Only the most serious bankers were involved; they worked with great dispatch, and they made decisions promptly. Certainly, a wider field of bankers will review a transaction if all costs, expenses, and other significant amounts are available up front and they have large moneys to be paid by way of commitment fees.

By the way, in this transaction, many of the major brokerage houses were, in fact, involved. Merrill Lynch was interested. Drexel Burnham was interested. There was no shortage of prominent, powerful investment bankers who were looking at this transaction and willing to proceed to finance it.

The genius of Mr. Weinberg was in recognizing that his approach of only agreeing to advance personally the direct costs incurred and pointing out that the company had not agreed to advance costs would, one, not hinder his ability to conclude the transaction; and, two, would save a substantial amount of money.

I would like to tell you that we had advised Mr. Weinberg while legally it was not perfectly clear under State law in our judgment as to the propriety of the expense reimbursement, it was highly likely that a challenge to the reimbursement by a shareholder, if the transaction were not successful, would fail. In other words, we felt that under Delaware law, the State of incorporation of SunMedia Corp., a shareholders' suit trying to set aside reimbursement would not be successful under the current state of the law.

As I said to you before, I'd like to discuss also some public policy considerations.

It is my position that this subcommittee must be concerned with management's negotiated entitlement to reimbursement when management attempts to buy out its shareholders. One is hard pressed to find a situation in which the law tolerates a raid on the corporate treasury for the personal benefit of management employees. State law, in case after case, seeks—no, they don't seek, they demand restitution for the personal use of corporate assets. How reimbursement for expenses incurred in an attempt to buy out

shareholders is distinguished from the cases where the courts challenged acts that are done for the personal benefit of an individual beggars my imagination. Companies belong to the shareholders, and, in a perfect world, they are run for their benefit. Courts do not countenance corporate expenditures for personal gain. Yet corporation after corporation enter into agreements reimbursing management attempting to buy out the corporation from its shareholders. This clearly appears to me to be using corporate assets for the personal benefit of management. The benefit is the proposed purchase of the entity by management using shareholder assets. Simplistically stated, the management group is buying the shareholders' stock with the shareholders' money, and using the shareholders' treasury to formulate and complete their program. Logically, this approach also diminishes the value of the corporation by removing from its treasury cash which is used to pay the bills management incurred.

There are situations which we recognize in the law where people are reimbursed. In the corporate sense, they are reimbursed when they are successful. Lawyers' plaintiffs are reimbursed when they bring a derivative action against the corporation and are successful because they have enriched the corporation. They are successful at that point, and they should be rewarded. There is another instance in which reimbursement is common. That's when there is a proxy fight. If and when the challenger wins his proxy fight, he can seek reimbursement and he is entitled to reimbursement. If he loses, if he fails, he's not reimbursed. I see no difference in those situations and the management buy out.

On its face, reimbursement appears to me and, I say, to the general public as a terrible conflict of interest. I'm hard pressed to find any similar conflict of interest that is tolerated in our society. This conflict, coupled with the open checkbook, I believe leads to overreaching transactions that this country and this committee cannot continue to condone. The riches that flow to management, investment bankers, and professionals patently diminish public confidence in our institutions, and that's sad. A vital capital formation market continues to be critical to a healthy country and a healthy economy.

Public policy arguments aside, these statements are not meant to demean key corporate management. Remember, I represent key corporate management. Their abilities are vital for corporate well-being. I frankly favor management being offered the opportunity to conclude an LBO. But it must be accomplished on a level playing field without shareholder detriment. Management has an advantage from the very first moment. Any buyer, even a strategic one, must keep the vast majority of the management people if the company is to be viable and is to survive after the buy out. Because of the unique knowledge management possesses, they are frankly the most logical buyer.

Before I conclude, gentlemen, I would like to address myself to another point which, while not applicable to the UAL transaction, is one I think this subcommittee must well address itself to.

As negotiations proceed in today's corporate market, it is common for management to negotiate not only the expense-reimbursement provisions—the payment provisions we've talked

about—but more often than not, they negotiate a fee that they will, in fact, be paid if they are not the successful bidder, if they do not gain control of the company. In today's market, those fees are enormous. The result of this is that management is enriching itself, again, at the corporate shareholders' expense, even if they are outbid, even if they fail to gain control of the company because it was worth more to another than they were prepared to bid for it. It's difficult for me to fathom how persons with no investment of their own and, in fact, with the free and unfettered use of funds belonging to the shareholders they seek to replace, are entitled to profit so handsomely if the transaction is not concluded by them because they are outbid. The profit from management losing is, again, a detriment to the shareholders and is at shareholders' expense.

Thank you very much for your time.

[The prepared statement of Mr. Krantz follows:]

STATEMENT OF BYRON S. KRANTZ

BEFORE THE SUBCOMMITTEE ON ANTITRUST,
MONOPOLIES AND BUSINESS RIGHTS,
COMMITTEE ON THE JUDICIARY OF THE
UNITED STATES SENATE

NOVEMBER 30, 1989

Background: I am a senior partner in the Cleveland, Ohio law firm of Kohrman Jackson & Krantz, a 30 person firm which devotes much of its practice time to transactional law. My background as a securities lawyer/litigator has led me to devote most of my practice time in recent years to representing management and deal groups interested in acquiring corporations through the use of leveraged buy-outs ("LBOs") as the means of financing the transactions. While virtually all transactions I have personally handled and have completed ranged in price from \$20-\$60 million, I have, from time to time, represented groups bidding in the \$200-\$300 million range. I received my B.A. degree in 1957 from Dartmouth College and my J.D. from Case Western Reserve University in 1962.

**Anatomy of the Expense Reimbursement
of a Recent Management Buy-out**

I would like to recount for this Subcommittee's benefit a management LBO that was successfully concluded just a few months ago without the benefit of any prior reimbursement agreement. The company, SunMedia Corp., owns suburban newspapers in Ohio and Wisconsin. The chairman of the company owned 7-1/2% of the company stock, the president owned 15% and other employees owned approximately 3%. The shareholders owning approximately 50% of the company were interested in selling SunMedia at the best price available. These shareholders were investors and not employed by SunMedia. Both the chairman and president prevailed upon the outside shareholders to allow them to have the first opportunity to purchase at a negotiated price.

The transaction cost of buying investor stock and retiring the investor debt was in excess of \$40 million. Instead of negotiating with the investor group for reimbursement of investment bankers' fees, commitment fees, due diligence fees and professional fees, Mr. Weinberg, the chairman, chose to advance the necessary fees. The reasoning was quite simple: if he succeeded in concluding the transaction, management's fees would be reimbursed from the proceeds of the acquisition. On the other hand, if management had used corporate funds to finance an attempted acquisition which ultimately failed, we felt the directors and Mr. Weinberg would be the subject of appropriate criticism for violation of fiduciary duty to the shareholders. Patently, the board of directors would have consented to the advancement. In any event, it was determined to be an inappropriate expenditure of corporate funds.

As a result of the restricted checkbook method of financing LBOs, Mr. Weinberg was able to negotiate fees to prospective lenders and bankers conditioned solely upon closing. The only costs advanced were the "due diligence" costs and reimbursement for out-of-pocket expenses incurred by the proposed lenders and bankers. This approach clearly benefitted the selling shareholders, the corporation and the buyers. Restricted expenditures have a leavening effect. Only the most serious bankers were involved; they worked with great dispatch and made decisions promptly. Certainly, a wider field of bankers will review a transaction if all costs, expenses and other

significant amounts are available up front and large sums of money are made immediately available for commitment fees. The facts, however, are that all those sums either diminish the value to shareholders or burden the acquirer, and neither event benefits the visiblity of the corporation.

The genius of Mr. Weinberg was in recognizing that his approach of only agreeing to advance, personally, the direct costs incurred and pointing out that the company had not agreed to advance costs, would (i) not hinder his ability to conclude the transaction, and (ii) would save a substantial amount of money. As a postscript, we counseled Mr. Weinberg that, while legally it was unclear under state law, in our judgment, as to the propriety of expense reimbursement, it was highly likely that a challenge to the reimbursement by a shareholder, if the transaction was not successful, would fail. SunMedia Corp. is a Delaware corporation.

Public Policy Consideration in Management Reimbursement

One is hard-pressed to find any situation in which the law tolerates a raid on the corporate treasury for the personal benefit of management employees. State law, in case after case, seeks restitution for personal use of corporate assets. Why the instant matter under consideration is distinguished beqgars one's imagination. The companies belong to the

shareholders and, in a perfect world, are run for their benefit. No court would tolerate corporate expenditure for personal benefit. Yet, corporation after corporation reimburse management for attempting to buy the corporation from its shareholders. This, clearly, seems to be using corporate assets for personal benefit. The benefit is the proposed purchase of the entity using only shareholder assets. Simplistically stated, management group is buying the shareholders' stock with the shareholders' money (the assets of the corporation) and using the shareholders' treasury to formulate and complete their program. Logically, this approach also diminishes the value of the corporation to shareholders by removing from the treasury the amount available to shareholders.

I am hard-pressed to find any similar conflict of interest that is tolerated in this society. The conflict, coupled with the open checkbook, I believe, leads to overreaching transactions that cannot continue to be condoned. The riches that flow to management, investment bankers and the professionals patently diminish public confidence in our institutions and that is sad. A vital capital formation market continues to be critical to a healthy country.

Public policy arguments aside, these statements are not meant to demean key corporate management. Their abilities are the key to a healthy corporation. I, frankly, favor management being offered the opportunity to conclude an LBO, but it must

be accomplished on a level playing field without shareholder detriment. Management has an advantage from the very first moment. Any buyer, even a strategic one, must keep the vast majority of the management people if they are to be vital and survive. Because of this and the unique knowledge management possesses, they are often the most logical buyer. However, as negotiations now proceed, they negotiate not only an expense reimbursement provision, but a break-up fee, thereby enriching themselves, again at corporate shareholders' expense, even if they are outbid. It is difficult to fathom how persons with no investment of their own and, in fact, with the free and untettered use of the funds belonging to the shareholders they seek to replace, can further profit handsomely if the transaction is not concluded because they are outbid. The profit from losing is similarly at shareholders' expense.

Senator METZENBAUM. Thank you very much, Mr. Krantz.

I'm very pleased to see that our colleague, Senator Specter, has joined us. Senator Specter, do you have an opening statement?

Senator SPECTER. I do not, Mr. Chairman. I am pleased to be here. We are in recess in the Senate, but I just returned to Washington and found this on the agenda. I'm glad to join you.

Senator METZENBAUM. Thank you very much. Happy to have you with us.

I had some questions. I think we'll have a 10-minute rule and then shift back and forth.

UAL claims that the agreement with the management group to reimburse its fees and expenses was reached in negotiations with independent directors. Mr. Krasner or Mr. Monks I think are more familiar with the particular transaction than Mr. Krantz. Do you believe these directors were really independent?

Mr. MONKS. Mr. Chairman, you have to think of the reality of the situation. And I wouldn't impugn anyone's integrity, nor would I pass a legal conclusion. But I'd ask you just to consider the dynamics. So long as the same chief executive officer is going to continue in his position irrespective of whether the transaction succeeds or fails, the problems of collegial relationship make it extremely difficult for the directors to put themselves in opposition with someone who, as a practical matter, probably selected them and, as a practical matter, is in the position to decide whether to re-select them.

It, therefore, seems to me that—nor do corporate directors generally have the same experience that you and Senator Specter and Senator Thurmond do of endlessly having coalitions of being on somebody's side one day and somebody else's side the next and have learned to live with it well. People who are corporate directors are not accustomed to confrontatory types of relationships. One does not become a corporate director if one expects to interpose such considerations. It's a body that generally in the modern standards functions through unanimity.

Therefore, Mr. Chairman, it isn't possible to look to a board as presently constituted for an independent judgment on this subject.

Senator METZENBAUM. Thank you.

Mr. Krasner, would you care to add anything?

Mr. KRASNER. Mr. Chairman, I agree with what Mr. Monks said on an objective level. One could point to each of these individuals and say he's not clearly associated with the management group in any way and, therefore, objectively he's independent. As a practical matter, however, people that have sat on the same board of directors together for years—people that, in the case of the outside directors, have entrusted the operation of this company to management—tend to rely on management and rely on the advice and the integrity of this management. If they felt that management was dishonest, they would disassociate themselves from the management. Until they feel that the management is dishonest, they tend to rely on that management. After all, management has the full-time obligation of running the company. The directors may sit on 10 or 15 other boards of directors, and they may operate their own businesses or their own professions. This is a small part-time occupation for them. As a consequence, they tend to rely on others.

Senator METZENBAUM. Thank you very much, Mr. Krasner.

Mr. Krantz, in this instance, the board of directors granted itself large pensions, \$20,000 a year, and lifetime unlimited travel privileges for each director and his or her spouse at the same time as agreeing to this deal. I don't know much more about it than that, but I would ask you whether or not you think that that does raise some question of conflict of interest of the directors.

Mr. KRANTZ. Senator Metzenbaum, it certainly taints the transaction. Any type of action which favors an individual and is done contemporaneously with the sale in which it is designed to enhance the benefits to that person actually smells. Basically, we used to talk at the time I was litigating a number of cases about a smell test, and the basic smell test is: If it looks like a duck and walks like a duck, it is a duck. This was done contemporaneously with the sale, and it obviously eroded their thoughts or changed their thoughts. It was a direct conflict. It should not have been done. Frankly, it should seriously be challenged. It's a very inappropriate act.

Senator METZENBAUM. Mr. Monks, are you aware of the fact which was brought to my attention that part of the reimbursement included a million dollars to Boone Pickens for his advice. Mr. Pickens, as I understand it, heads up a group that he's formed called United Shareholders of America. It's my understanding that that money was paid to him back maybe as long ago as some time in 1987, and he has not been more recently involved. But when the pilots were seeking advice as to how to put this deal together, they went to him and he was paid \$1 million consultation fee.

Mr. MONKS. I was not, Mr. Chairman.

Senator METZENBAUM. Do you think, Mr. Monks, that management sought this deal to maximize shareholder value, or were they more particularly interested in protecting their own positions by preventing Marvin Davis from acquiring the company?

Mr. MONKS. I can't attribute motives to the management personnel. I don't know them; I'm not familiar with them.

My view, Mr. Chairman, is that this transaction takes place in an environment, an important element of which are the laws that are applicable, and that the tendency for people to want to enrich themselves will develop in accordance with the outlines of the law. One of the great ironies here, Mr. Chairman, is that in 1973, when there was genuine concern by the Federal Government about the buy-back, the privatization of companies and the advantage of management doing so, the SEC promulgated so-called rule 13(e) in connection with the Mary Wells repurchase. As so many Government acts occur, this has unintended consequences, and the consequences were far from outlawing management buyouts. What it did was it provided a framework within which people could proceed, apparently safely because they complied with the SEC requirements.

So one of the unintended consequences of a well-intended Government action was to create exactly the framework down which managements could safely proceed. That, Mr. Chairman, is why these transactions take the form they do.

Senator METZENBAUM. I might just correct my own question. My notes indicates Mr. Pickens was paid \$1.5 million, not \$1 million. I would just have the recorder correct that, please.

Mr. MONKS. I am equally ignorant of the last half a million.

Senator METZENBAUM. I understand that.

Are you aware of the fact that the reimbursement to the pilots included their expenses going back over a period of about 3 years? Were you aware of that?

Mr. MONKS. I was not aware of that, Mr. Chairman.

Senator METZENBAUM. Mr. Krasner or Mr. Krantz, either one of you, what standard would a court apply in evaluating whether this fee reimbursement agreement violated the board's fiduciary duty to its shareholders? As I understand, Mr. Krantz, your testimony was that a shareholder probably could not challenge this agreement, although, as I understand it, there doesn't seem to be that much case law on the issue. But your point in your testimony was that in any other case where there was a matter of management using corporate funds for its own purposes would be forbidden. But in this instance, a question does exist. Did you do any research as to what the law is on this subject?

Mr. KRANTZ. I am going to share this answer, Senator Metzenbaum, with Mr. Krasner who can add something to it.

We advised our client Mr. Weinberg—and we've advised other clients in exactly the same situation—that while the general consensus among today's well-known, high-powered LBO lawyers is that reimbursement agreements are valid, in our considered judgment we felt that, if challenged and challenged continually, that ultimately someone will prevail and set some of these reimbursement agreements aside.

We spent 6 hours on LEXIS, which is today's modern method of trying to determine what the law is, to try to find a case decided in Delaware that was similar to the UAL situation. Using very good research people, they were not able to come up with any case. Mr. Krasner, however, advises me that he believes there is one case that may be related, and that's the *J.P. Stevens* case, and I think he can speak to that.

Mr. KRASNER. Yes, Mr. Chairman. In our research, we did come across one case, and that is the *J.P. Stevens* decision which was handed down on April 9, 1988, by the Court of Chancery of Delaware. It involved a takeover battle between the management of J.P. Stevens and another public company called West Point Pepperel. Management had entered into an agreement which included, among other things, a provision for reimbursement if the transaction failed, which, in fact, at that point it ultimately did. And West Point Pepperel attacked the agreement on that ground, and the vice chancellor did hold that under those circumstances the agreement was appropriate. This was Vice Chancellor Allen.

We are unaware of any upper court or any Supreme Court decision in Delaware or elsewhere holding the same. We do know, as a matter of fact, that generally corporate attorneys have advised boards of directors under similar circumstances that these agreements are proper. However, as Mr. Krantz points out, I am aware of many instances where attorneys have advised directors that while these agreements may be proper, they are certainly question-

able. The morality of that kind of an agreement is certainly open to dispute.

Senator METZENBAUM. Thank you very much, Mr. Krasner. I might say that this committee does not sit as a court. We don't determine legal questions. Those are issues for the courts. This committee sits as a committee that makes laws. And if there is a law that is interpreted by the courts that's contrary to what we determine it ought to be, then we try to or we do change the law.

At this point, I would say that I will ask my staff to get back in touch with Mr. Hoenicke, senior vice president and general counsel of the company—who has advised us in writing, "The legality and appropriateness of such provisions have been accepted by the courts in Delaware and other jurisdictions"—to ask whether he has any additional information he cares to supply the committee with in that connection.

Senator Thurmond.

Senator THURMOND. Thank you, Mr. Chairman.

Mr. Monks, in your testimony, you mentioned the role of the board of directors, especially those disinterested or independent directors. Is it true that they can act as a buffer in a management buy-out or a force that provides the balance and fairness that is needed in this kind of situation, especially since they are subject to shareholder suits for a breach of their obligations?

Mr. MONKS. Senator Thurmond, in answering that question, I would like to share with you my personal experience. I was chairman of the board of a bank in—I come from New England—in Boston, and I owned 18 percent of the stock of the bank. And one of the alternatives that was available to us was to try to privatize the company. In fact, what we did is merged into what is now American Express Co.

In doing that, I had a good lawyer, and I asked him how to proceed, and the procedures were, as I mentioned in answer to the chairman's question, outlined by the SEC. One of the elements in that process would be to go to the board and to get the legal approval. As a practical matter, the board members were people with whom I had worked for many years and they were friends of mine, and Boston is a small city. There is no question in my mind but that the board members would have given that approval and that I would have had legal sanction for what I did. But I personally came to the conclusion, Mr. Chairman, that there were only two ways that the transaction—I'm sorry, Mr. Former Chairman—there were only two ways that the transaction could have come out. One is I would have paid too much money, which I couldn't afford, and the other was that I would have paid too little money, in which case I would have been deemed as someone who had wrongly dealt with people who trusted me, and I would have put my friends—the independent directors—into a position of great embarrassment. And while they would have provided me with legal protection, it would have been something that would have been a source of opprobrium to them in the community in the days to come.

Therefore, while I think there is some narrow legal comfort to be taken in independent directors as a real matter, I personally concluded that it would not be availing.

Mr. KRASNER. Senator Thurmond, if I could add something to that? Clearly, independent directors can be a buffer between the management and the shareholders and can represent the interests of the shareholders. The question really is: Do they? And is the reality of corporate life such that they can exercise real independence under these kinds of circumstances when they're dealing with the very same people who are their colleagues and who they sit across the table from every single day.

Senator THURMOND. Mr. Monks, do you feel we need legislation in this area, and do you feel the courts are not able to deal with any overreaching or unfairness through shareholder derivative suits?

Mr. MONKS. Mr. Chairman, I've had the honor to be responsible for administering at least three Federal statutes. Having had that experience, I can promise you—perhaps even more than your own much more extensive experience—gives you great humility as to whether Federal legislation is a constructive answer to any problem. Indeed, you might say if Federal is the answer, God help us for what the question is.

I will say in this particular instance, Mr. Chairman, that I do believe that a carefully drafted, very limited Federal legislation is uniquely the answer. The reason is this, in my opinion: You've oftentimes heard, I'm sure, in this body the expression "race to the bottom." And the difficulty of our system of having 50 alternative places of incorporation has been characterized by former SEC Chairman Carey as a race to the bottom.

You could ask yourselves why do we have a situation like we have. It seems so plainly wrong. I hear these three gentlemen, and they're not notably lunatics. How could we possibly have a situation like this?

The problem, Senator Thurmond, in my view is that the States, in competition with each other to be a domicile of convenience—and, after all, it's managements who choose the corporate domicile. It has no impact on the business of the corporation—and the courts as well, who, after all, are not unmindful of politics—have, in effect, created a momentum for the erosion of this important protection.

In brief, I think the States have made a mess of it, and it's only in a situation where the States have made a mess of it that I think preemptive Federal involvement is constructive. Here what I would propose that you be asked to do is something where there's precedent. I mentioned earlier my experience with ERISA, and I mentioned sections 408 and 406 of ERISA, which relates to the pension assets of the country, which is an enormous number. I would recommend, Mr. Chairman, that legislation along the line of sections 406 and 408 of ERISA, which prohibits self-dealing by fiduciaries but also provides for a mechanism whereby, yes, with a cumbersome process with an administrative agency it can be done because there may be cases where it's possible. But to my way of thinking, Senator Thurmond, it would be a constructive thing to try to restore this level of essential trust to the American economic system, and I know of no other or better way than for Federal legislation.

Senator THURMOND. Mr. Krasner, let me ask you the same question I asked Mr. Monks. Is legislation really necessary in this area?

Are the courts able to deal with these issues through the shareholder derivative suits?

Mr. KRASNER. Senator Thurmond, I've had a great deal of experience with shareholder derivative suits, and in this particular area, the law has been eroded time and time again. Courts of Delaware, which have primarily dealt with this problem, have over the years tended to weaken the shareholder protections and enhanced the position of the management in these transactions.

It was not too many years ago that the Supreme Court of Delaware enunciated a decision in a case called *Singer v. Magnavox*, in which it said that there had to be a business justification for a management buyout. Over the years, that decision has been eroded to the point that there need be no justification at all for a management buy out other than a desire by management to enrich itself and a willingness to pay whatever the price might be to achieve that goal.

The courts of Delaware are constantly threatened by lawyers and by managements that if they come down on the wrong side of a particular issue corporations will reincorporate somewhere else. It was not too long ago that one of the leading corporate lawyers in New York, after an unfavorable decision in Delaware involving a poison pill defense, said, well, if this is what the courts of Delaware are going to do, my clients are going to go elsewhere and take their incorporation business to some other State.

With this kind of threat hanging over the legal and judicial system in Delaware, it's not surprising to find that the Delaware courts are becoming weaker and weaker in enforcing shareholder rights. If a corporation did not have the choice of reincorporating in the most favorable forum, I think that Federal legislation would be unnecessary. But given that fact, the only body that can, in effect, create a law of corporate governance for these types of transactions is the Federal Government.

Senator THURMOND. Mr. Krasner, you note that the agreement between UAL and management provides for the payment of management's expenses, whether management's efforts were successful or not. Is the UAL agreement different from other agreements in this regard? In other words, is it more common for a reimbursement agreement to provide for repayment only in the event of a successful bid?

Mr. KRASNER. I think in my experience it has become more common than it used to be; 10, 12 years ago, even 7, 8 years ago, it was uncommon. It is only in the past 4, 5, 6 years that it has become common, and in part it has become common because of the erosion of the Delaware law, because Delaware courts countenance this. And once the shareholder representatives, the directors are told it's legal to do it, they'll do it because that's their benchmark: Can I get sued for doing it? It's not: Is it the right thing or is it the wrong thing? It's: Can I get sued and can they recover money from me?

I'm saying that even if the Delaware courts say it's legal to do it, the more elementary and basic question is: Is it right to do it? And that's not a question that directors of corporations are confronting today.

Mr. Krantz' example is the exception rather than the rule, and I think he would agree with that.

Senator THURMOND. Mr. Krasner, would you mind elaborating on and provide specific examples about the inherent unfair advantage management has in a going private transaction?

Mr. KRASNER. Yes. Management has the most basic advantage; that is, management has access to all of the internal financial information of a company. Generally, corporations only publish to the public historical results. Corporations do not publish projections. They do not publish the most elementary information as to where they think the company is going to be 2 or 3 years hence. Management has all that information at its fingertips. So that from the point of view of looking forward, management is well in advance of anybody else.

It is this kind of information that bankers are most interested in when called upon to finance a transaction. So when management of a corporation goes to a large bank and says I want financing for the transaction, the first thing the bank will ask is: What is your business plan? What is the company going to look like 3 years from now? What do you project its earnings to be? Management can take out all those computer printouts and demonstrate where they think the company is going to be with a great deal of assurance. Anybody sitting on the outside has nowhere near that kind of information. That's one area.

The second area is in the relationship between management and the other directors. The outside directors are generally sitting on the board of directors because they've been invited to do so by management. And even if they are outsiders, they certainly feel a certain kinship to the management that brought them on the board and to the people that they sit next to at board of directors meetings and probably socialize with on other occasions. So management has a personal advantage over the outsiders.

Third, management can time the transaction in such a way as to create the greatest amount of benefit to itself. Management can, without public scrutiny, create all of the financing for the transaction and suddenly spring the transaction on the public at a particular moment in time that they choose, and say we're going to offer a certain amount of money for this company, but you've got to accept the offer within 30 days. Otherwise, we're going to withdraw the offer. That puts tremendous pressure on the board to either accept the offer or see the price of its stock decline if the offer is not forthcoming.

They create the timeframe for the offer, and they choose the timing of the offer. These are the three greatest advantages that management has in any of these transactions.

Senator THURMOND. Thank you, Mr. Chairman.

Senator METZENBAUM. Thank you, Mr. Krasner. Thank you, Senator Thurmond.

Senator Specter?

Senator SPECTER. Thank you, Mr. Chairman.

Mr. Krasner, do you believe that the conduct by the management on this United Airlines transaction constitutes fraud?

Mr. KRASNER. The common definition of fraud is to mislead someone by either a misstatement or an omission and to mislead

them to their detriment. I can't say that here. This was publicly known at the time the offer was made, that this agreement existed, yes.

Senator SPECTER. Do you believe it constitutes a breach of their fiduciary responsibility?

Mr. KRASNER. Yes, I do.

Senator SPECTER. Is there no facet of the existing Securities Act legislation which covers breach of fiduciary duty in such circumstances?

Mr. KRASNER. In Federal law, no. Federal law generally applies to what you've called fraud-type transactions, transactions involving purchases and sales of securities. The Supreme Court has several times stated that any issues involving corporate governance are not controlled by the Federal securities laws but are controlled by State law. I think the *Santa Fe* decision by the U.S. Supreme Court is the most outstanding example of that.

Senator SPECTER. Has Federal legislation moved into such a comparable area on a breach of fiduciary duty in any other circumstance, to your knowledge?

Mr. KRASNER. Yes. I believe Mr. Monks pointed out they have done that in the pension area.

Senator SPECTER. Anything besides the pension area?

Mr. KRASNER. Offhand, I'm not aware of it.

Senator SPECTER. Well, there's a special reason, of course, with the employee plans, but my inquiry goes to just how broad there ought to be a pursuit by the Federal Government in this kind of a line. I've been provided with one legal memorandum which summarizes the *J.P. Stevens* decision to this effect: that the issue turns on whether the action is necessary to maximize shareholder value, and I think the contrast with that would be whether or not it's for the special interest of the insider group. Do you think that that's a fair statement of the Stevens holding?

Mr. KRASNER. Well, it's not really. There are two issues in Stevens, and the issue that that's directed to was another provision in that agreement, which was that if a higher offer was subsequently made in this—this was a bidding contest. If a higher offer were subsequently made, then the offering group, which included management and Odyssey Partners, would get a fee for having put the highest offer on the table to begin with.

I don't think that the court intended that to apply to this reimbursement provision. On the reimbursement provision, the court went off on the theory that this was a business judgment by the directors.

Senator SPECTER. Well, if the real purpose was to benefit the insiders as opposed to benefiting the shareholders, then would the rationale of the court strike that down?

Mr. KRASNER. Clearly, if the purpose of the transaction was solely to benefit the insiders, the rationale would strike it down. But in the real world, nothing is ever that black or that white.

Senator SPECTER. But it seems to me that that's what we're—I'm trying to isolate the issue to see what are the underlying values at stake and whether the State remedy which exists is accurate. And as I understand the delineation, it turns on whether the real purpose is for the insiders or whether the real purpose is for the share-

holders. And I understand that in legal matters, as in so many other matters, it's not black and white.

But that is essentially the question which the court has to decide, is it not?

Mr. KRASNER. Senator Specter, it's not really that simple. As Mr. Krantz pointed out and as I have seen in my experience, investment bankers and lawyers and others are prepared to work on a contingent basis in a transaction like this. The board of directors never inquired as to whether these people——

Senator SPECTER. Mr. Krasner, Mr. Krasner, let me interrupt you because I've only got 10 minutes.

Mr. KRASNER. I'm sorry.

Senator SPECTER. I'm trying to limit it to one witness, not to exclude anybody else, but you can barely get a couple of ideas across in 10 minutes. I'd just like to develop the point further. I regret the interruption, but I do want to move to a point as to what more Federal legislation could accomplish.

If we were to legislate federally, we would have to set the values that are about the same, whether it is for the shareholders or whether it is for the insiders. And you might say predominantly or principally. But to what extent would the Federal legislation be able to more clearly articulate that pointed issue for resolution by a court? We are not going to legislate federally on some different standard. That would be the standard. How are we going to improve what the State law now provides?

Mr. KRASNER. I think Federal legislation could improve what State law provides by setting certain minimum standards. For example, there should be an outright prohibition against reimbursement of expense by a bidder.

Senator SPECTER. Well, why if it's for the interest of the shareholders?

Mr. KRASNER. Because it has never been shown empirically to be in the interest of the shareholders to have bidders reimbursed for their expenses.

Senator SPECTER. So you think that's just something that ought to be flat out prohibited——

Mr. KRASNER. Absolutely.

Senator SPECTER [continuing]. And the Delaware courts have missed the point in not doing so?

Mr. KRASNER. Absolutely. I think the Delaware courts have been deluded by this statement that somehow this encourages bidding. I don't think it encourages bidding.

Senator SPECTER. Mr. Monks, are you petitioning to intervene?

Mr. MONKS. I did.

Senator SPECTER. Go ahead.

Mr. MONKS. Possibly you'll get your time extended as a result of your graciousness.

Senator SPECTER. I doubt it. But go ahead.

Mr. MONKS. If there's anything more worrying than preemptive Federal legislation, it is courts applying economics. The thing that——

Senator SPECTER. Think Senators can do a better job at that?

Mr. MONKS. Well, the buck stops at you, and so it's a moot question. You have to.

When I think of the question that you were posing to Mr. Krasner, what you're talking about is a world in which the ultimate good is theoretical economics. There is here a much more important question at work. It takes a theologian to figure out whether something intends to be for the benefit of the management or for the shareholders as a whole. If—

Senator SPECTER. Well, we have juries for that.

Mr. MONKS. If there is, as I maintain there is—and I think I mentioned my dealings with your former colleague, Senator Javits, somewhat earlier in this regard. But at the risk of being repetitive, Senator Javits referred to this as being a very great evil, self-dealing by trustees, by fiduciaries. If you adopt a per se test that says that the self-dealing period, period, is illegal, then you create a framework within which people know how to conduct themselves. The question of what is wrong here is that so long as there are these level of subjective questions trying to be dealt with by courts who are necessarily in a competitive world for trying to be the congenial host to corporate domiciles, you're going to get the wrong answer—

Senator SPECTER. Courts are in a competitive world for being congenial hosts to domiciliary corporations?

Mr. MONKS. Absolutely. Absolutely. As you well know, the reference that Mr. Krasner—

Senator SPECTER. Have you ever articulated that argument in Delaware?

Mr. MONKS. Yes. And the State they hold up is your own.

Senator SPECTER. They what?

Mr. MONKS. I say the State that they cite as being the preferred situs is Pennsylvania.

Senator SPECTER. Well, I'd have to agree with that.

Mr. MONKS. The problem is that if you leave a level of ambiguity here and you're dealing with people who really can't in a competitive way enforce standards—

Senator SPECTER. Well, Mr. Monks, there's no doubt that self-dealing by trustees is abhorrent, but the question is: How do you define self-dealing? Now, we've talked about independent directors, and I understand the problems, but it's really a case-by-case, factual determination.

One level of the issue is: How do you improve the situation on a corporate board beyond having independent directors? If they are inappropriately biased, if they are biased toward a corporation, they have risks as not exercising independent judgment in their fiduciary capacity. But when you institutionalize or structure, what can you do better than have a category of independent directors and do your best to apply on a case-by-case basis the appropriate discharge of their duties?

Mr. MONKS. I would respectfully submit, Senator Specter, that the best evidence of a bankruptcy of that policy is the last 3 or 4 years. Independent directors have been unable to deal effectively with what is I think concededly a very serious problem.

Senator SPECTER. You're saying that the shareholder suits and the line of questioning pursued by Senator Thurmond have been totally ineffective?

Mr. MONKS. They're very ineffective. The trouble, with all respect to Mr. Krasner—and we've tried to figure out ways to make them more effective. The difficulty is that most of say my clients, institutional shareholders, do not want to spend their time and energy and associate themselves with these things. The difficulty we have is: Can we begin to have a world in which shareholders are owners, or are shareholders just going to be holders of pieces of paper? And for the long-term health of the United States, I think we all want to work to make shareholders owners, which they're not at the moment.

Senator SPECTER. Well, I quite agree with you that shareholders ought to be owners. That's the black letter and the difficulty, and complication arises as you apply it to specific cases in terms of what insiders do and what independent directors may do. We face a very tough threshold question.

I see the red light, Mr. Chairman, and I shall conclude with just a comment or two, having taken by your gesture that my time is not to be extended.

We face a very hard threshold question as to how far the Federal Government ought to intervene in these kinds of matters. And we are going to give a lot of attention to this issue, probably 2 hours today on our questions, not nearly as much as the court did in the case to which we have referred. We have to approach with caution the issue of trying to legislate on these matters, so there has to be a very strong case presented to us. But I think it is something that we ought to look into. I believe that there's a great deal which is being undertaken by insiders, which raises real issues that ought to be considered by the Congress.

I'm disappointed to see that the United Airlines people are not here today, and I note that there is a letter from Mr. Wolf, the chairman and president of United Airlines, which says that:

The company and its advisors are, among other things, exploring the possibility of structuring a new employee-led buyout. Thus, it was concluded that our participation in your public hearing could prejudice such discussions to the detriment of our shareholders.

And I intend to pursue this to see just exactly what is going on there because I think it would be helpful to the subcommittee if UAL were here—although let me say at the same time that I have grave reluctance about legislating for a specific case. I think as a general rule we ought not to legislate on a pending transaction. But if it is illustrative of a problem that is widespread, then it's an appropriate matter for our action. But I would, as a general rule, think we would legislate prospectively only.

I do think that these are important questions, but I would exercise caution in terms of how far the Congress goes in getting into matters which have been traditionally left to the purview of the States or making blanket judgments that the Chancery of Delaware is not discharging its duty appropriately or being excessively hospitable for domiciliary corporations.

Thank you, Mr. Chairman.

Senator METZENBAUM. Thank you very much, Senator Specter. I might say that I would not favor legislation that dealt only with a corporate situation, but this is not unique. As a matter of fact, as Mr. Krasner has pointed out, and Mr. Krantz as well, this is be-

coming more the rule rather than the exception, and there's been a change over the last 8 or 10 years, to the point where the investment bankers and the lawyers, in this Senator's opinion, have been getting pretty much of a free ride. And nobody is looking at really what's occurring, but, frankly, I think it has a negative impact upon the whole free enterprise system because I don't think it's healthy.

You have the Wall Street Journal today reporting on this particular situation, in which they point out that the fees that UAL owes for the failed \$6.79 billion bailout: Salomon Brothers and investment bankers, \$16.6 million; Citicorp and Chase Manhattan, lead banks for the buy-out group, \$8 million; Paul, Weiss, Rifkind, Wharton, and Garrison, the pilots law firm for the bid, \$6.8 million; Skadden, Arps, Slate, Meagher & Flom, the law firm for UAL management led by Chairman Stephen Wolf, and also the firm of Kaplan, Strangis & Kaplan—Mr. Strangis is a member of the board of UAL—that firm is a Minneapolis law firm of UAL directors, about \$5 million. Mr. Strangis, as I understand it, excused himself from his responsibilities as a director in connection with this matter. His law firm was paid quite handsomely. Wachtel, Lipton, Rosen & Katz, the investment bank's law firm, \$2 million; Cohn, Weiss & Simon, the pilots' labor law firm, \$1,375,000; Salomon Brothers, just a fee for a commitment, a bridge loan commitment, \$3 million; the pilots' Employee Stock Ownership Fund which had been working on this matter for about 3 years, \$16 million. It's my understanding that amount has already been paid out.

Now, I think one comment from the Wall Street Journal article is an interesting one, and I'm going to read it into the record.

More than \$8.25 million has gone to the Wall Street house of Lazard Freres & Co. for helping the UAL pilots union fail, along with UAL management, to buy the company. Lazard won't say just what its three investment bankers plus some support staff did to earn its fee.

This I believe is the significant part of the paragraph.

But let's assume the professionals worked 7 full days 1 week from the time the latest buy-out effort began, August 7, until the \$6.79 billion deal collapsed October 13. That still comes to \$41,045 per banker per day.

I know bankers come pretty high-priced. I was in the banking business at one point in my life. I never saw a banker, investment banker or any other kind, worth \$41,000 a day on a continued basis. They might be worth it for 1 day's work but not over a period of time. And my guess is they didn't devote full time to this issue.

I, therefore, conclude my comments, questions, with one last: Given the excessive fees being paid to the people doing these deals, is there a threat that the players rather than the economic soundness of the deal are driving many of these deals? I'd just ask each of you to respond briefly. Mr. Krantz.

Mr. KRANTZ. The profit motive on the investment bankers is a driving force. But what you have to understand is those enormous fees also have to be repaid, and they have to be repaid from the operation. And those enormous fees also decrease the amount of money that ultimately go to the shareholders who own the company.

You can't legislate reasonable fees, but it's very interesting to watch people when they're using their own money negotiate reasonable fees. These are much more reasonable when it's coming out of my pocket than when it's coming out of the corporate treasury. And I think that is the effect that we have to find somewhere in this society.

Senator METZENBAUM. Thank you, Mr. Krantz.

Mr. Krasner.

Mr. KRASNER. I think, in fact, an empirical study of many of the buy-out transactions of the past 2 years will show that many of them were, in fact, instigated by the very bankers and lawyers who profit from these transactions. In many instances, they are the ones that make the initial suggestion that the transaction could and should be accomplished. Clearly, the reason for that is the fees that are being generated by these transactions.

To add to that, the payment of these fees, even when the transaction doesn't succeed and is not consummated, makes it even more of an encouragement to these investment bankers and lawyers to generate these transactions if they know with assurance that no matter what ultimately happens they're going to get paid.

Senator METZENBAUM. Thank you, Mr. Krasner.

Mr. Monks.

Mr. MONKS. I have nothing to add on that point, but I'd be grateful for a minute to speak to a question raised by Former Chairman Thurmond and Senator Specter.

Senator METZENBAUM. Surely.

Mr. MONKS. I feel that Federal involvement should only be encouraged in extremis, only as the last resort. It is in that spirit I'd like to have my testimony couched.

I'd like to share with you an experience that I've had. I've been a member of two State corporation commissions that have spent a number of years involving all segments of their policies trying to consider what should States do about the takeover situation. These are California, where I'm on the Senate Commission under Senator McKorkindale, and the Commonwealth of Massachusetts. One extraordinary result from both of these States, which I think you could agree are complicated and difficult constituencies, was that they ended up exhorting the Federal Government to preempt the field.

I find that to be extraordinary in view of the ancient history of turf and what have you. I wanted to share that experience with you. In my own experience, two State commissions studying the subject for 3 years have said: We can't find a solution within the Federal system. What California says is: 5 years ago, 40 of the Fortune 500 were incorporated in California, today three. If we're going to be preempted by somebody—we're now being preempted by Delaware—we'd rather be preempted by the Federal Government. At least we have some kind of input there.

Senator METZENBAUM. Thank you very much, Mr. Monks.

Senator Thurmond, do you have wind-up question?

Senator THURMOND. Mr. Krantz, I just want to ask you a question. Would Mr. Weinberg's approach to the buyout of SunMedia Corporation have been feasible in the management buyout of UAL?

Mr. KRANTZ. Senator Thurmond, I hope I'm competent to answer that question, but I am not going to sit here and say that I'm totally competent. I have never been involved in a buyout of that magnitude. I do, however, believe that his approach would, from what I have been able to glean and from my dealing with investment bankers, have been a feasible way to do it.

We have signed a number of management buy-out agreements whereby the fees were paid upon the successful conclusion of the transaction and only upon that. That is in addition to Mr. Weinberg's. I think Mr. Weinberg's approach also, as I've said before, moderates the amount of money that is spent. I find some of these amounts of money to be, frankly, sir, obscene. In many respects, it is no more difficult to buy the SunMedia Corp. than it is to buy a \$3 billion corporation. We still go through the same amount of paperwork. We still go through the same amount of proxies. We still go through the same amount of disclosure. We may not deal with as many bankers, and we may not have as many commitment fees or bridge loan fees. But, nevertheless, there's an enormous amount of work that is done and an enormous amount of work that's paid for. The fees in that transaction were in excess, well in excess of \$1 million for everybody that was involved, certainly—substantially in excess of \$1 million. But those were all paid upon the completion of the transaction. You could then look at it and find out if the transaction itself was a buyable transaction, and you would, in fact, be able to repay your debt at that time.

Senator THURMOND. Mr. Krantz, would you recommend against all reimbursement agreements or only those which provide for reimbursement even if the transaction fails?

Mr. KRANTZ. I totally believe in a reimbursement agreement if the transaction is successful, sir. Reimbursement should only be conditioned upon the success of the transaction. I also would advise against any kind of topping fee if you lose the transaction. I think that just directly takes money out of the shareholders' hands.

Senator THURMOND. Mr. Krantz, you note in your written testimony that you are "hard pressed to find any situation in which the law tolerates a raid on the corporate treasury for the personal benefit of management employees." Yet my understanding of the law is that courts have allowed these reimbursement agreements when the board has determined that such fees are necessary to maximize shareholder value. Are the courts wrong in concluding that shareholders are benefiting in these situations?

Mr. KRANTZ. Well, Senator Thurmond, as I said, we attempted to find cases in which the courts did, in fact, say this. Mr. Krasner has pointed out the only case he could find was the *J.P. Stevens* case. In doing this for a living, I don't quite understand how a management buyout maximizes shareholder values. I do not understand the logic of that approach. The maximum value to the shareholders is attained when a corporation's stock is put into play. If the members of management come and start putting the stock up and bidding for the stock, and that puts the stock into play and there are other players, then you've maximized shareholder values. If they don't come and bid, then you similarly maximize shareholder values. But today's agreements do not maximize shareholder values because they literally put impediments in the road of some-

body bidding for the corporation, and that's often done by the topping fees and the reimbursement agreements, which literally take money out of the treasury which would have to be repaid by the group buying the company.

If I am bidding for UAL, sir, I have \$53 million less in UAL than UAL management has, because I'm not only paying my own fees in bidding for UAL, I'm also paying the management fees in bidding for UAL because they paid it by agreement.

Senator THURMOND. Mr. Krantz, you referred to the expression "level playing field." Would you mind explaining for the record just what you mean by a level playing field?

Mr. KRANTZ. I said that in this line, sir: I said:

I frankly favor management being offered the opportunity to conclude an LBO, but it must be accomplished on a level playing field without shareholder detriment.

Those are exactly the same comments I was making before.

I think management should play by exactly the same rules as the third-party bidder would play by. The third-party bidder would pay his own expenses, would make his own arrangements, and would not be given any specific benefit, such as a topping fee or something of that nature. That is what I meant by a level playing field. The directors of the company ought to be able to deal with their management and afford them the opportunity to buy at the same terms as another party would buy, but not to give them a special advantage because they were, in fact, management, because, in fact, I think that acts to the shareholder detriment.

Senator THURMOND. I want to thank all of you gentlemen for your appearance here, and we'll be in recess just 1 minute or 2 until the chairman returns.

[Pause.]

Senator METZENBAUM. I just want to express my appreciation to the witnesses who participated, and I know at some personal inconvenience to each of you. But I think the hearing brought to light many facts that need to be known. We'll certainly consider whether or not we ought to go down the legislative road. And if UAL, the pilots, anyone else wishes to be heard further, I'm not certain as to whether we'll have another hearing, but we'll certainly be happy to arrange for their comments to be submitted. We'll keep the record open for about 1 week.

Thank you very much. The hearing stands adjourned.

[Whereupon, at 11:23 a.m., the subcommittee was adjourned, subject to the call of the Chair.]

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